EXPOSURE DRAFT OF A BOOK-IN-PROGRESS

PUBLICATION DATE: 5 MONTHS AFTER 250 PRE-ORDERS ARE RECEIVED BY INKSHARES, A PUBLISHER THAT RELIES ON CROWDFUNDING TO DECIDE WHAT TO PUBLISH. SEE https://www.inkshares.com/projects/the-fairshare-model

THE FAIRSHARE MODEL

A PERFORMANCE BASED CAPITAL STRUCTURE FOR RAISING VENTURE CAPITAL VIA AN INITIAL PUBLIC OFFERING (IPO)

BY KARL M. SJOGREN

SEND COMMENTS, SUGGESTIONS & EDITS TO karl@fairsharemodel.com

Chapters 1 through 18 as of Mar. 15, 2016

What's new:

- The first two chapters of the prior exposure draft are reorganized into three chapters. As a result, the subsequent chapters are renumbered (i.e., old #4 is now #5, what was #10 is now #11, etc.)
- The first chapter is on Inkshares (link above) and I am soliciting pre-orders. If you like the Fairshare Model, please show your support with a pre-order. With the credit Inkshares that issues a new customer, an e-book will cost you just USD $10---an e-book + signed print copy combo, $15.

Table of Contents

Just for once I'd like to see all these things sort of straightened out, with each person getting exactly what he deserves. It might give me some confidence in this universe.

The men were perfectly content to fly as many missions as we asked them as long as they thought they had no alternative. Now you've given them hope, and they're unhappy. So the blame is all yours.

Both lines above are from the novel *Catch-22* by Joseph Heller

One of the things I learned the hard way was that it doesn't pay to get discouraged. Keeping busy and making optimism a way of life can restore your faith in yourself. Lucille Ball (actress and comedienne)

Some men see things as they are and ask "why?" Others dream things that never were and ask "why not?"

George Bernard Shaw

Introduction to the Mar 15, 2016 exposure draft

This book promotes the concept of a performance-based capital structure for venture-stage companies that seek to raise venture capital using a public offering.

I call it the Fairshare Model because it seeks to balance and align the interests of those who provide capital and those who work to create value in a company. It's strictly an idea; no company I'm aware of has adopted anything similar.

This version represents about 90 percent of a full initial draft. I am, so to speak, open kimono with this material; it needs editing and better diagrams. I share it with you, Dear Reader, in order to have a better end product. If you think I'm misstated or overlooked something, I welcome your comments. Also, I hope to hear from you feel if something is unclear or, even worse, boring! My goal is to give both experts and those who are new to capital structures a way to re-imagine capitalism. I seek to deliver a "Ha!" or an "Aha!" every page or two. Please let me know where you think I could do it better.

The unwritten chapters will touch on behavioral finance, game theory, secondary market and financial reporting issues. I am exploring publishing options as I write them. I expect to use a crowdfunding campaign to fund the editing and design work needed to self-publish a print and e-book. If you can help me in this effort or have other ideas, please contact me at karl@fairsharemodel.com

The Fairshare Model is neither liberal nor conservative but it is iconoclastic; its principles appeal to anyone who cares about economic growth and fairness.

The book will be published about five months after 750 pre-orders are received by Inkshares, a publisher that decides what projects to back based on reader support. With the credit that Inkshares issues to new customers, an e-book will set you back USD $10---an e-book + signed print copy combo, $15.

I am a consulting chief financial officer in the San Francisco Bay area who enjoys thinking about how to improve capital formation. In the 90s, I was CEO of a company that sought to innovate in this space--see chapter six, My Path to the Fairshare Model, for my background.

Section I: Fairshare Model Overview

There is a better way to provide venture capital to young companies; better for individual investors, especially unaccredited ones, better for entrepreneurs and better for employees who work at these companies.

The Fairshare Model is designed to grow the economic pie and improve the opportunity for capital gains for individuals who invest in or work for such companies.

Map

Section I kicks off with analogous thinking about about capital structures. Then, the Fairshare Model is presented and the problem with a conventional capital structure for venture-stage initial public offerings. Crowdfunding is discussed along with a description of the types of companies that may adopt the Fairshare Model. The section closes with the history of the model and a projection for how it will become the New Normal.

Section II explores two macro-economic contexts for the Fairshare Model—economic growth and income inequality. Also, the potential to use the ability to cooperate as a competitive tool and philosophical points about the Fairshare Model.

Section III returns to the technical matter of valuation; it considers concepts, mechanics and evaluation.

Section IV discusses the concerns that some have about efforts to make it easer and less expensive for companies to sell stock to average investors.

Chapters in this section:

Chapter 1: The Fairshare Model

Preview

- Foreword
- Purpose of this book
- Audience
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- Encouragement and a compass
- Vision
- Goal
- Problem
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- Chicken vs. Egg
- Thesis
- A Bird's Eye View of the thesis
- Onward

Foreword

This chapter addresses the context for the Fairshare Model and describes what it is.

Purpose of this book

The purpose of this book is to spark broad discussion about how to re-imagine capitalism at the DNA level. A capital structure is a company's DNA—it defines ownership interests and voting rights—so everything that capitalism is (or can be) flows from the expression of qualities that originates in its capital structure.

The Fairshare Model is an idea for a performance-based capital structure for companies that raise venture capital via *a public offering*. Its mission is to balance and align the interests of investors and employees; to offer public investors a deal comparable to what venture capitalists get.

It has two classes of stock. One trades, the other cannot; both vote. Investors get the tradable stock, which is called "Investor Stock." For past performance, employees get it too. For future performance, employees get the non-tradable stock, which is called "Performance Stock." Based on milestones, Performance Stock converts into Investor Stock. The model's structure is simple; its complexity flows from a philosophical question, "what is performance?" How that question is answered will vary—it can be whatever a company's shareholders say it will be.

The idea behind the Fairshare Model is simultaneously radical and ordinary.

It is radical because the model presents a very different philosophy about how to structure ownership interests in public companies whose value chiefly comes from their uncertain promise of future performance. Such companies have raised venture capital for decades via Wall Street initial public offerings and recent changes in securities law will accelerate such activity. Another way the Fairshare Model is a radical idea is that it presents a way for Middle Class investors to participate in venture capital investing on terms comparable to what venture capitalists get.

The Fairshare Model is ordinary because it encourages the public capital markets to work the way most markets work, where sellers compete for buyers by offering a better deal (i.e., lower prices and better terms). Remarkably, this isn't common with a conventional capital structure; companies don't compete for public investors by offering lower valuations and better protections.

This reflects *weak market forces* that exists because IPO issuers and Wall Street firms don't want to compete on terms and because many public investors are not valuation savvy; they are unsure what valuation is, how to calculate it and how to evaluate one. Oftentimes, "market forces" is a phrase used to explain adverse developments for the Middle Class, but they can bring better deals to average investors. One way to reimagine capitalism is with *stronger* market forces that result in a better product and increased competition for public capital. The Fairshare Model promotes this in a win-win manner—with significant benefits for investors and employees.

So, how does one go about changing the DNA of capitalism? By popularizing a new philosophy about the relationship between companies and their IPO investors. The key idea? Treat public venture capital like private venture capital. That is, provide IPO investors price protection, comparable to what venture capital firms get in a private offering, then, reward well-performing entrepreneurial teams with more ownership than they would get in a private offering to a venture capital firm.

I hope you'll discuss the Fairshare Model with others. Generating interest—"buzz" among hives of people with interest in entrepreneurial companies—is the job of this book. As the model's philosophy gains traction, all manner of experts will evaluate how to implement it for different types of companies; that will only happen if there is clear investor interest in the model. Then, some companies will try it!

Think of this process like baking the sourdough bread that the San Francisco Bay area is renowned for. This book will serve as the "starter," the yeast culture that gives the bread its unique flavor and texture. Readers like you will contribute ingredients to make a dough, but instead of flour and water, you will provide ideas and enthusiasm. Experts in various matters—law, tax, accounting, organizational development and others—will knead it. Once this dough rises, early adopters will try it. The aroma of a fresh approach to capital formation will attract more people to the kitchen who contribute more ideas on what to make.

Often, after I'm exposed to a new idea I see other things in a new light. I get pleasure when this happens—I view it as a reward of being curious. I trust that you feel similarly, Dear Reader. I seek to engage you in new thinking about capital markets, an interplay between concept and possibility, analysis and imagination. And I hope you'll similarly engage others who will, in turn, do the same. So, let's begin to explore how to reimagine capital formation, the DNA of capitalism!

Audience

First and foremost, this is a book for thinkers; practical minded people who like big ideas.

My principal target audience is comprised of investors who might want to invest in a start-up company someday. Some of them see a problem—such companies are notoriously difficult to value. For them, the Fairshare Model is a solution because it avoids the need to value undelivered performance.

My secondary target audience is comprised of entrepreneurs who are willing to consider a public offering as an alternative to a VC round.

There is another audience that is important, but my attention isn't focused on them now. It is attorneys, accountants, investment bankers and portals, stock exchanges and others involved in the emerging company eco-system. Their involvement is needed to help implement the Fairshare Model.

Broadly, this book will appeal to those who are interested in the following:

- Economic philosophy and behavioral finance
- Valuation theory (in an easy to understand manner)
- Corporate governance and organizational behavior;
- How to align the interests of investors and employees;
- The intersection of social investing and capital markets;
- Economic growth and a partial solution to income inequality that does not rely on taxes.

Why I focus on valuation

I emphasize the importance of valuation for public investors. A *Wall Street Journal* article succinctly states why buy-in valuation deserves to be emphasized. [Bold added for emphasis]

> *An enormous body of academic research has proved time and again that* ***your long-term investment returns will overwhelmingly depend*** *instead* ***upon*** *just two things: asset allocation—how you spread your money between investments like stocks and bonds—and* ***the value of those investments when you buy them****.*

Dear Reader, have you noticed news stories that mention valuation? They are far more common than a decade ago. Do you puzzle over the amounts and wonder how to evaluate them? Do you know the difference between pre- and post money valuation? Subsequent chapters discuss valuation concepts in a manner that anyone can understand. You will learn how to calculate a company's valuation, how venture capitalists evaluate one and how they protect themselves from investing at too high a valuation.

Questions about valuation are about to bloom as a result of the Jumpstart Our Business Startups Act of 2012, also known as the JOBS Act. It led to changes to securities regulations that makes it less expensive and difficult for young companies to sell stock to public investors.

Encouragement and a compass

There may be times when points that I make are unclear to readers who are unfamiliar with capital structures. Dear Reader, I offer two things to deal with moments when you feel disoriented.

Every page or two, I hope to give you a "Ha!" or "Aha!"

The first is encouragement. Stick with me and matters that seem obscure will come into focus. You will acquire a credible view of how capital formation works in a capitalistic economy. I make technical points in simple language. Philosophy, analogy and humor are in my toolbox. Make this journey and you'll have a better understanding of a complex socio-economic process that affects many aspects of life. If you don't already have one, you'll acquire a credible, coherent point of view about the IPO market for early stage companies. If you already have such a perspective, I may challenge it. Either way, if you like ideas, this book will be fun!

The second thing that I offer you is a conceptual compass. With respect to how capital formation works, between where we are now and where I imagine we can be, is unexplored terrain. When you wonder where I am headed, where I will turn, how I think a matter should be settled, look to my compass. *On it*, *True North is the interests of public investors who buy stock from a venture-stage company in an IPO.* The interests of entrepreneurs, private investors and investors in the secondary market are important, but not as central as those of IPO investors; there is only one True North.

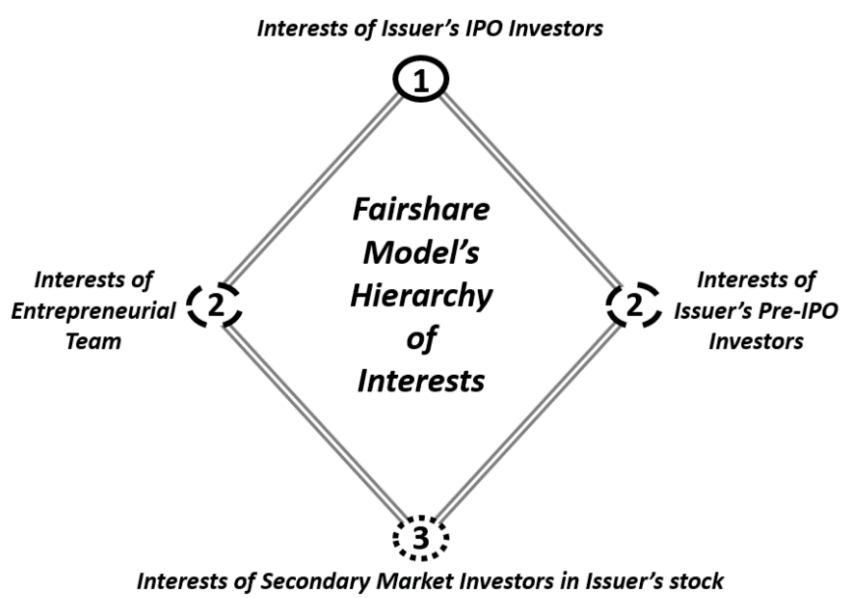
Public IPO investors occupy that position for the Fairshare Model because if they make money, there will be more money for entrepreneurs and their private investors.

In the Fairshare Model's hierarchy of interests—IPO investors are at the top. So, the answer to any question about how to make the Fairshare Model work will likely be found by asking "What is best for the IPO investors?" while giving due consideration to the interests of the other key constituencies.

This ranking hierarchy is diagramed at the right. The interests of IPO investors are at the top, in the #1 spot.

The interests of the entrepreneurial team and the interests of pre-IPO investors (i.e., angels, VCs) are tied at the #2 spot.

The interests of secondary market investors occupy the #3 spot.



Vision

My vision for the Fairshare Model is that average investors will be able to make venture capital investments…*on terms that are comparable to those that professional investors get.*

Goal

My goal is a deal structure that will:

1. Expand entrepreneur access to capital.
2. Offer liquidity to wealthy angel investors who support private companies.
3. Create an attractive yet prudent option for average investors to be “mini angel” investors.

Note the self-renewing cycle. Entrepreneurs are more likely to attract capital if investors feel fairly treated for the risks they assume. Angel investors are more likely to invest when they believe it can attract investors to the next round of capital, and, there is the prospect of liquidity (the ability to sell shares). Public investors are more likely to provide that capital and liquidity if they, too, feel fairly treated.

Within a generation, I hope that the Fairshare Model will be seen as a viable and attractive approach for companies that raise venture capital in a public offering. This will happen if it helps them raise capital and provides competitive advantage in attracting employees and managing them.

Problem

A conventional capital structure is a weak model for a self-renewing cycle of capital because it has a fundamental problem—a need to set a value on *future* performance anytime equity capital is raised. This is hard to do in a reliable manner, but a conventional model demands that be done.

There is a work-around to this problem in a private venture capital offering; valuation-savvy investors negotiate a valuation and price protection. But there is no work-around in an IPO, which is increasingly used to raise a round of venture capital. So, public investors have a problem—many of them are valuation unaware, the valuation is set by the issuer, and they have no price protection even though they assume significant risks. These conceptual formulas show the problem.

Private VC Round	**=**	**All Investors are Valuation Aware**	**+**	**Negotiated Valuation**	**+**	**Price Protection**

versus

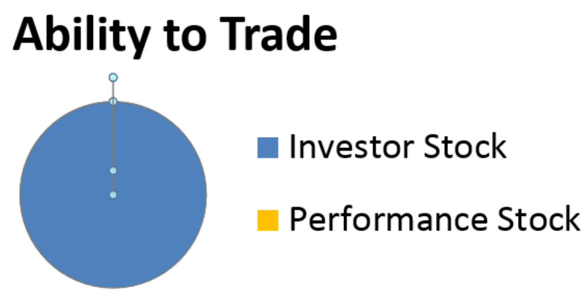
Public VC Round (IPO)	**=**	**Many Investors are Valuation Unaware**	**+**	**Valuation Set by Issuer**	**+**	**No Price Protection**

Before public investors can solve their problem, they must first realize that they have one—that they are treated relatively poorly. Then, they need to support ways to solve it. The Fairshare Model is one such solution because it provides a VC-like deal structure for IPO investors; it treats them fairly.

The Fairshare Model

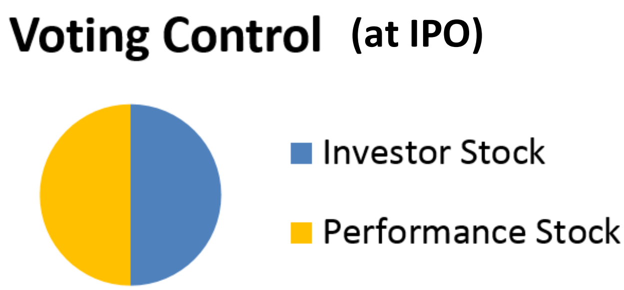
The Fairshare Model is for a company (an "issuer" of securities) that raises venture capital via a public offering. There are two classes of stock. One can trade, the other cannot; both can vote.

I refer to the tradable stock as **Investor Stock**; it is sold to investors to raise equity capital for the company. From a legal perspective, Investor Stock is common stock.



I refer to the non-tradable stock as **Performance Stock**; it is issued to employees, consultants, directors and others. From a legal perspective, Performance Stock is preferred stock.

Investor Stock always has at least 50% of the voting power, even when it represents less than 50% of the total shares issued.



At the IPO, there is far more Performance Stock than Investor Stock, perhaps ten times more, enough to envision years of future performance but, as a class, Investor Stock has at least half the voting power. So, even if Performance Stock is 80 percent of total shares and Investor Stock is 20 percent, Investor Stock has 50 percent of the voting power. However, when Performance Stock represents less than 50 percent of total shares, voting is based on issued shares, not class. Therefore, if Performance Stock represents 40 percent of total shares, it has 40 percent of the vote and Investor Stock has 60 percent.

Based on performance milestones agreed to by the two classes of stock, Performance Stock converts to Investor Stock. There will be variation in how performance is defined and measured based on:

- Industry; software, manufacturing, services, biotech, etc.
- Stage of development; pre-revenue, early growth, late growth, mature, etc.
- Corporate purpose; a socially conscious issuer may have non-traditional goals.
- Geography; countries and regions may favor certain approaches.
- Personalities of the entrepreneurial team and their investors.

The performance criteria is in the issuer's incorporation document and offering document (i.e., prospectus, registration statement). It may be modified by agreement of both classes of stock.

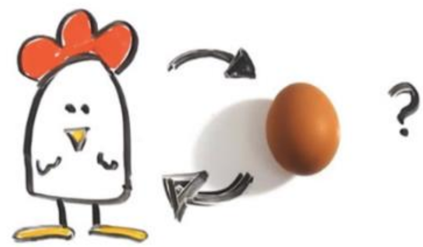
Ordinarily, an offer to acquire the company must be approved by both classes of stock. Such an event may cause a very significant conversion of Performance Stock.

Chicken vs. Egg

No company has used the Fairshare Model. It's entirely conceptual. I have no anecdotes about how it has actually worked.

What I can tell you is that about fifteen years ago, in 1997, I co-founded a company called Fairshare that promoted the Fairshare Model and a plan to implement it. We had some success (e.g., a robust educational website, 16,000 op-in members) before we slipped under the waves in 2001, in the wake of the dotcom and telecom busts.

I touch on my Fairshare adventure in later chapters. One lesson that I learned is how to address the Chicken vs. Egg conundrum. Companies will adopt a new capital structure if there is an audience for it. Investors want to see companies using it before they get enthusiastic about it. The movie "Field of Dreams" has a line to describe to such a challenge, "If you build it and they will come." In our case, was the "it" an opportunity to invest in a specific company that used the Fairshare Model? Or, was "it" an audience of investors interested in the Fairshare Model? Which comes first?



For a couple of reasons, we decided that the latter approach, build the audience, was the most practical. The most important one was that companies we wanted to attract could raise capital in other ways. There would be no reason for them to craft an offering using our novel structure before there were investors who liked it. Also, garnering support for an idea *before it is implemented* has an advantage. When a particular implementation represents an idea, attention is directed to its specific attributes and away from the idea. All companies have shortcomings so having some become the "poster child" for the Fairshare Model risked making their flaws the focal point, not the Big Idea. This issue come up in politics. It is why politicians prefer to campaign on a Big Idea rather than on a specific proposal (i.e., "I'm for a balanced budget" vs. "I want to cut these programs or raise these taxes").

Some suggested another option—persuade venture capitalists and investment bankers to support the Fairshare Model. Well, that would be greeted with the interest that a high end retailer has for a competing discount store. In fact, when I pitched the Fairshare concept to a prominent San Francisco based VC in the late 1990s, his response was "*Why would I be interested in THAT*?"

Much has changed since then but not that sentiment, I'm sure. However, fast forward a half dozen years or so from now. Once the model's effectiveness is demonstrated, a new breed of VC is likely to consider using it. Perhaps, it will be to fund a new round for a portfolio company that is a single or double in baseball-speak, not a triple or home run. A boutique VC fund might use a Fairshare Model IPO to bring in public investors to co-invest. This would limit the amount of capital the VC needs to raise, allow early customers to have a piece of the action, and provide liquidity for the fund's limited partners. There is similar potential for new style of broker-dealer to create a niche market in investment banking using the Fairshare Model.

For such things to happen, VCs and broker-dealers need to see that there is a market for the model, and, that there is money to be made. This will take time and experience, but it will happen, I'm certain, because of the problem that exists when applying a conventional capital structure to a start-up. As public investors become savvier, many will have interest in a better deal.

So, I lead with an idea because it's all I've got. If enough people visualize the egg, intrepid (not-so-chicken) entrepreneurs will give it a go. A community of experts will grow to help other companies figure out how to make the Fairshare Model work for them. Supportive infrastructure will develop. A self-sustaining community of integrated interests will form…organically, if you will.

How many people are needed to give the Fairshare Model the traction that it needs? Half of a small fraction of those who supported the Occupy Wall Street protests. There were enough of them to attract wide attention to their dissatisfaction with The-Way-Things-Are. It doesn't take many to spark a revolution—the Boston Tea Party wasn't large either.

When protestors demonstrate (it doesn't matter why), they channel Howard Beale, the fictional television anchor in the 1976 movie, *Network*. One night Beale snaps. He's enraged that his network is abandoning "hard news" for news that generates high ratings. On a live broadcast, he exhorts his audience to stop being mere observers of the problems that define their existence. In part, he says:

> *So I want you to get up now. I want all of you to get up out of your chairs. I want you to get up right now and go to the window. Open it, and stick your head out, and yell, 'I'M AS MAD AS HELL, AND I'M NOT GOING TO TAKE THIS ANYMORE!'*
>
> *I want you to get up right now, sit up, go to your windows, open them and stick your head out and yell - 'I'm as mad as hell and I'm not going to take this anymore!'*
>
> *Things have got to change. But first, you've gotta get mad! You've got to say, 'I'm as mad as hell, and I'm not going to take this anymore!'*

Beale's speech expresses anger and frustration…negative energy. It mobilizes, which is why political campaigns favor negative ads. Ironically, though, negative energy is the opposite of what is needed to turn things around. To build something better, one requires positive energy—optimism, creativity and cooperation.

I rely on positive energy to solve my chicken and egg puzzle.

How many people might have to express interest in the Fairshare Model to get it on the proving grounds? My guess is 20,000, but it could be less than 10,000. No big deal. In 2014, a guy raised $55,000 from 7,000 people on Kickstarter to make a potato salad. Google it.

If there is investor interest in the Fairshare Model, some companies will try to raise capital using it. If enough of them have good results, more will come.

Thesis

Average investors lack an attractive, prudent way to invest in young companies. The opportunity to innovate in this space reveals itself when one considers venture capital from the perspective of public investors. Normally, venture capital is viewed from the perspective of entrepreneurs, venture capitalists, wealthy investors and Wall Street firms. But look at it from the perspective of public investors and it looks arrestingly different, like the shift from black and white to color in *The Wizard of Oz* movie.

Make this shift in perspective and the Fairshare Model is intuitive, even to those who know little about venture capital. Those with knowledge about capital formation will recognize similarities between the Fairshare Model and how VCs construct their deals. Dear Reader, as you contemplate The-Way-Things-Are, a question will form in your mind. *Why should public investors who invest in venture stage companies be treated so poorly?* Then, another question will arise. *What can be done to change this?*

The Fairshare Model is an innovation in deal structure that treats IPO investors as venture partners as opposed to inhabitants at the bottom of the capital market food chain. To achieve its goals, it adopts a different approach to IPO valuation. Essentially, it extends the concept of price protection from the private VC market to the public VC market. To extend the *Oz* metaphor, investors have to see the capital markets "in color" to appreciate this idea, which is what this book will help them to do.

Early stage companies are hard to value because virtually all their value comes from future performance, which is steeped in uncertainty. A conventional capital structure demands that a value be placed on future performance each time new stock is sold. VCs skirt this problem by securing deal terms that retroactively lowers their buy-in valuation if expectations are not met. Public investors don't get similar protection when they buy shares in a public venture-stage company.

For public investors, the risk of buying stock at an excessive valuation will grow as a result of the JOBS Act of 2012 because more unproven companies will seek capital from them. The risk can be mitigated by improving investor awareness about valuations. This risk can be reduced with the Fairshare Model because it eliminates the need to value undelivered performance.

The Fairshare Model was conceived to solve a micro-economic problem—how to enable public investors to invest on terms comparable to VCs. It incidentally offers ideas on macro-economic challenges such as slow economic growth and rising income inequality. In both a small and large sense, the Fairshare Model reimagines capitalism. Its challenges rest on human behavior, not technical matters.

For companies, the promise of the Fairshare Model is twofold. First, it will be easier for them to raise money because they can offer investors a better deal than with a conventional capital structure. Second, it will provide them with a competitive advantage when recruiting and managing human capital.

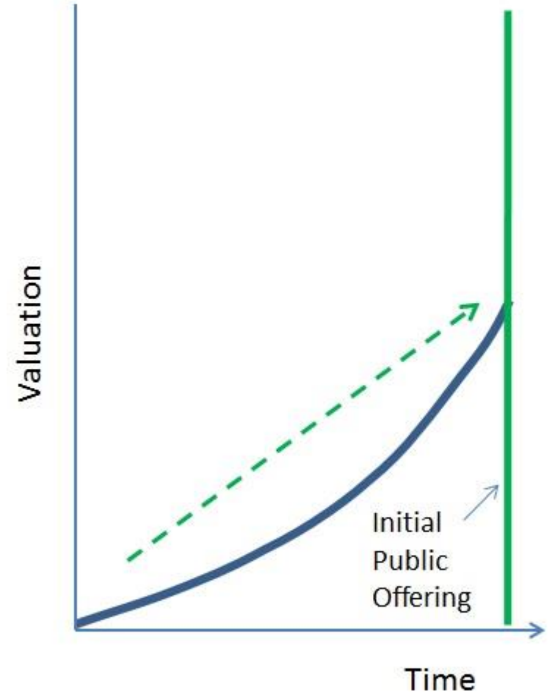
A Bird's Eye View of the Thesis

The next few charts illustrate what the valuation curve often looks like for a company that uses a conventional capital structure.

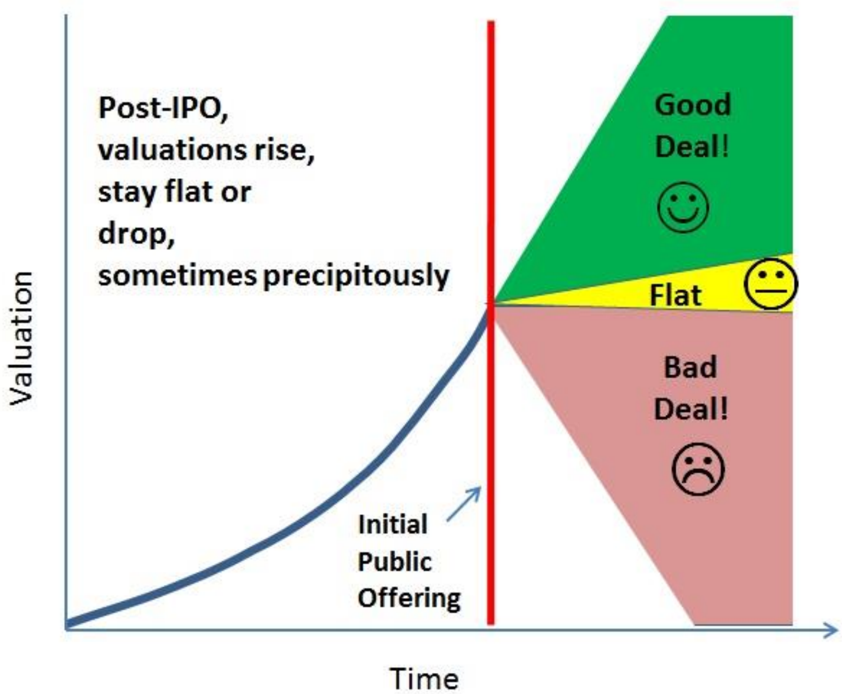
What drives the increase in valuation that often occurs as a company approaches its IPO when a conventional capital structure is used?

Is it performance?

Or, is it something else?

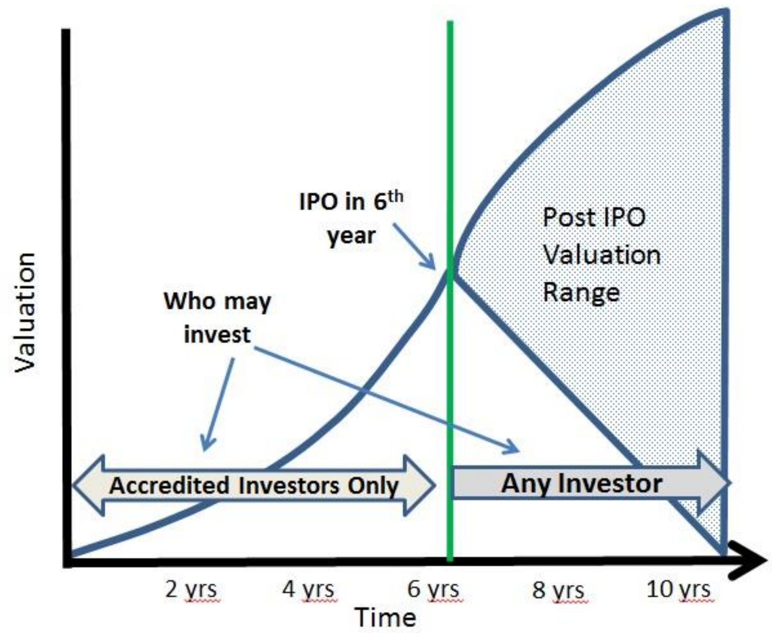


From the perspective of public investors, what are the risks that the IPO valuation presents?

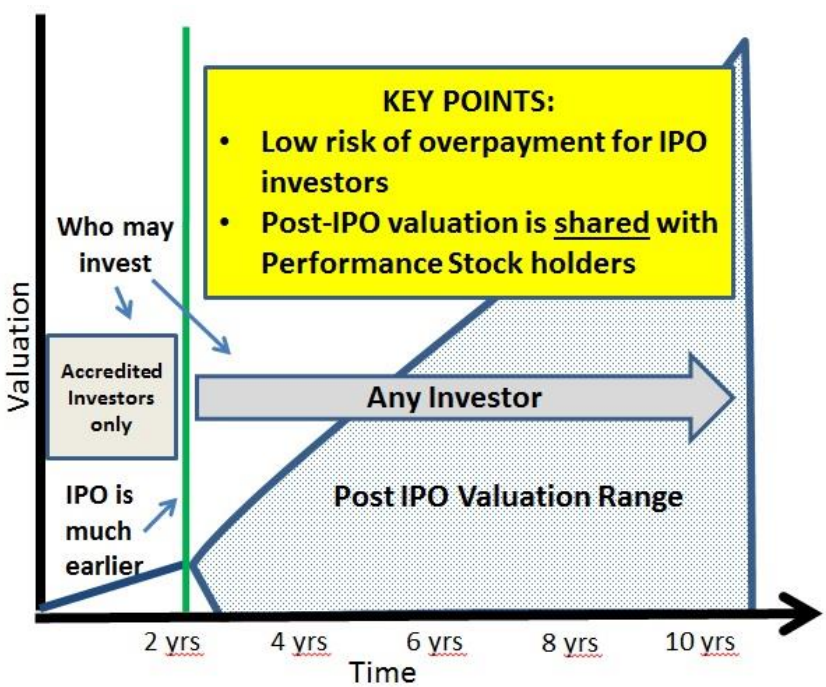


In this chart, the company has its IPO in its sixth year. However, if it were sooner, the valuation curve would look similar if a conventional capital structure is used. That's because companies tend to be valued higher when they are public and, so, private companies rise in value as expectations of a public offering heighten.

Note that only investors who are wealthy enough to meet the "accredited investor" standard defined by the U.S. Securities and Exchange Commission are allowed to invest in a private company; but anyone can invest in a public company

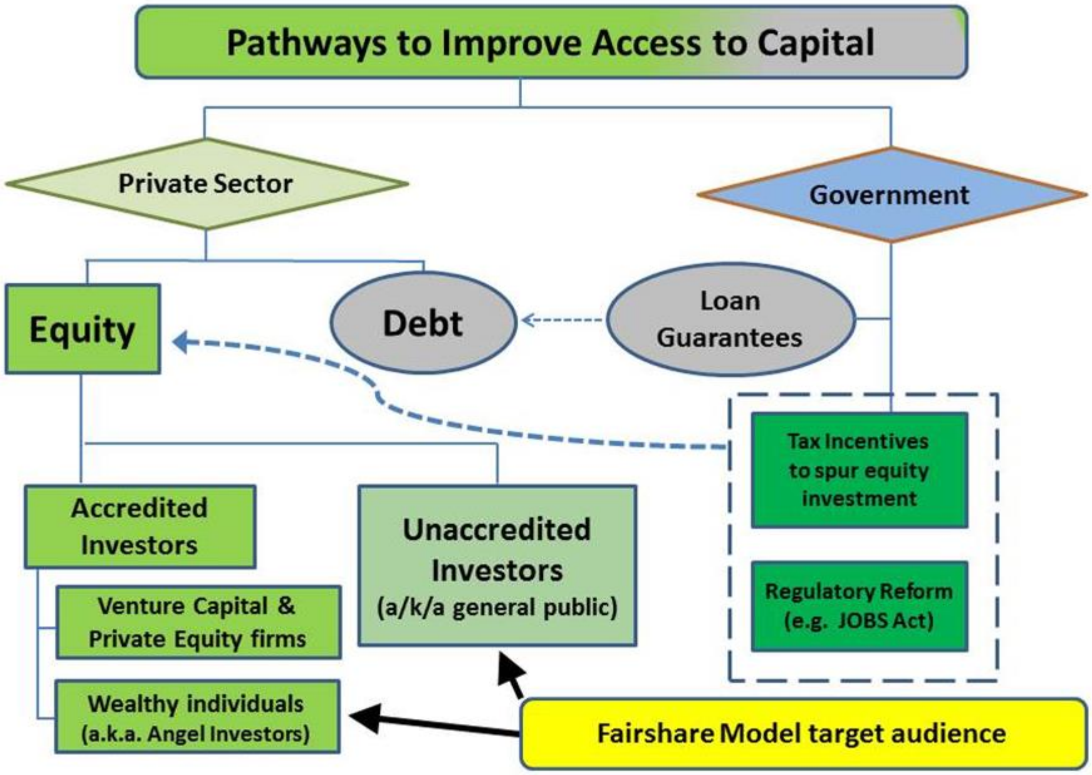


The Fairshare Model encourages companies to offer IPO investors a private venture capital valuation. In the chart below, the issuer goes public sooner, in year two, at a much lower valuation. If it performs, the increase in valuation is shared by the investors and employees. If it doesn't perform, public IPO investors lose less because the valuation was lower.



What is the issuer's incentive to offer a low IPO valuation? A well-performing team can own more of the company than they would if a VC backed them. Plus, they can be more competitive in attracting and managing human capital.

To be clear, the Fairshare Model is for a public offering of equity, one that can be sold to any investor. Its goal is to provide them a deal that is similar to what institutional investors—venture capital and private equity firms—get when they invest via a private offering. The chart below shows that there are two pathways to improve access to capital for companies—the private sector or government.



Government capital is available to a small proportion of companies (e.g., defense, energy, healthcare), often a loan guarantee, not equity. Government can spur the availability of capital via tax incentives and regulatory reform such as those in the JOBS Act.

Most equity capital comes from the private sector via private and public offerings. Only accredited investors (i.e. institutions and wealthy individuals) may invest in a private offering but anyone, including unaccredited or average investors, can invest in a public one. By meeting the requirements to offer stock to anyone, a company becomes "public" even if it is a startup.

A company that issues stock in a public offering (an issuer) can sell shares directly to the public in a direct public offering or hire a broker-dealer to sell them. The Fairshare Model can be used for any public offering—it is not dependent on how the shares are sold—and it's target audience is individual investors, be they accredited or not.

The macro-economic benefit of the Fairshare Model?

Young companies are the engine of economic growth and job creation—it follows that improving their ability to raise capital should provide social benefits in the form of economic growth, even after considering that the investments face high risk of failure.

The Fairshare Model does not reduce the *risk of failure* for IPO investors. It reduces the *cost of failure* when measured by the cost of owning a given percentage of a company.

It is analogous to the casino game of roulette. Imagine that each chip represents a given percentage of ownership in a company. The Fairshare Model does not change the odds that a given bet will pay off, rather, it reduces the cost of each chip. This allows the gambler to place bets on more numbers for the same money. More bets on start-ups could pay off, in a macro-economic sense. The Fairshare Model reduces the cost of a given bet because the investor need not pay for future performance before it is delivered. When it is delivered, it is shared with employees using whatever logic they choose to adopt.

This activity has a less obvious social benefit. Even when ventures fail, they contribute to a risk-taking, innovation-seeking culture. Such a culture is richer, more vibrant and productive in the long run than one that is timid. The national psyche is healthier when it pursues possibilities and accepts failure.

Another benefit of the Fairshare Model is that is a private sector approach to reduce income inequality; it does something without the need to achieve elusive political consensus. It does this by enabling employees to benefit from the wealth they create for investors. Put another way, we live in a time when the return on capital exceeds the return on labor, and, this dynamic is unlikely to change. The model addresses income inequality because it provides a vehicle for the providers of labor to participate in the return on capital generated by their labor.

The Fairshare Model rethinks capitalism, but it needs your interest, Dear Reader, and thousands of others to get off the ground.

> *If America is to continue to be the place where ordinary people find stimulation, challenge, novelty and fulfillment, our business sector will need more dynamism and inclusion than it has shown lately.*
>
> *This will require a restructuring of the financial sector to serve business innovation. The tiny band of "angel investors" and venture capitalists can't do it all.*
>
> Professor Edmund S. Phelps
> Director of Columbia University's Center on Capitalism and Society
> Winner of the 2006 Nobel Prize in Economics

Onward

The next chapter is for readers who are unfamiliar with capital structures or think that this book may be too difficult to understand.

Chapter 2: Orientation

Preview

- Foreword
- How this book is organized
- Capital structures as art
- Why capital structures deserve your attention
- Capital structures and sex
- Fairshare Model - The movie
- Onward

Foreword

If you are well-versed in capital formation matters, you'll be intrigued by the Fairshare Model. Ultimately however, **my goal is to reach people who know little about this subject.** Some will be eager to learn. Others will hesitate because they think capital structures must be boring or that learning about them will be difficult. **If this is you, Dear Reader, please stick with me**.

Having two very different target audiences places me on the horns of a dilemma. Which one determines how I present the case for the Fairshare Model?

This chapter reassures readers who are new to capital structures that they might enjoy this book.

If you are familiar with capital structures, feel free to skip or scan this chapter. The following one returns to substantive matters about the Fairshare Model.

How this book is organized

Organizationally, the first section rapidly hits a number of technical, micro-economic points. It's written for those knowledgeable about capital structures but in a way that a novice can follow. The second section goes into a macro-economic discussion about growth, job creation, income inequality and philosophy. Dear Reader, if the first section seems too technical, skim it, read the second section and then return to the first. Later sections tackle valuation and other matters in as approachable a manner as I can muster.

To aid navigation, the table of contents is detailed and each chapter opens with the subtopics. Stylistically, I favor a light manner. I also provoke; inspired by Diogenes, the ancient Greek philosopher to whom the following is attributed—"*Of what use is a philosopher who never offends anybody?"*

I serve-up ideas using a literary adaptation of "pointillism", a technique of painting in which dots outline and form an image. Here, ideas serve as dots and I share images that I see. You will surely see dots too and as you consider the images they form, ask yourself "What is really going on here?" Then, ask yourself "Is there a better way?"

To simplify ideas, I sometimes use a conceptual equation. This approach was inspired by Chip Conley's 2012 book *Emotional Equations*. Chip is founder of the Joie de Vivre hotel chain and now heads strategy at Airbnb, a startup in the vanguard of the "sharing economy." He came to his book in an effort to analyze emotions that he struggled with. A friend suggested that he find a way to express a feeling as a formula, to focus his attention on the variables that cause the emotion. For example:

Anxiety = Uncertainty X Powerlessness

This emotional equation states that anxiety is a multiple of uncertainty and powerlessness. It suggests that one can reduce anxiety by reducing uncertainty or the sense of powerlessness, or both.

My favorite equation was suggested by a caller when Chip was interviewed on a radio program[1]

Happiness = What is Happening - Expectations

This states that happiness can be increased by improving what is happening, reducing your expectations or both.

Substantively, these emotional equations are insightful. Stylistically, they de-tangle a complex subject. So, occasionally, I repurposed the concept as a conceptual equation like this:

Performance = Results - Expectations

This formula states that performance has a positive value when results exceed expectations, which helps shed light on a slippery question, "what is performance?"

[1] Chip Conley's interview on KQED's Forum program is here http://www.kqed.org/a/forum/R201201111000

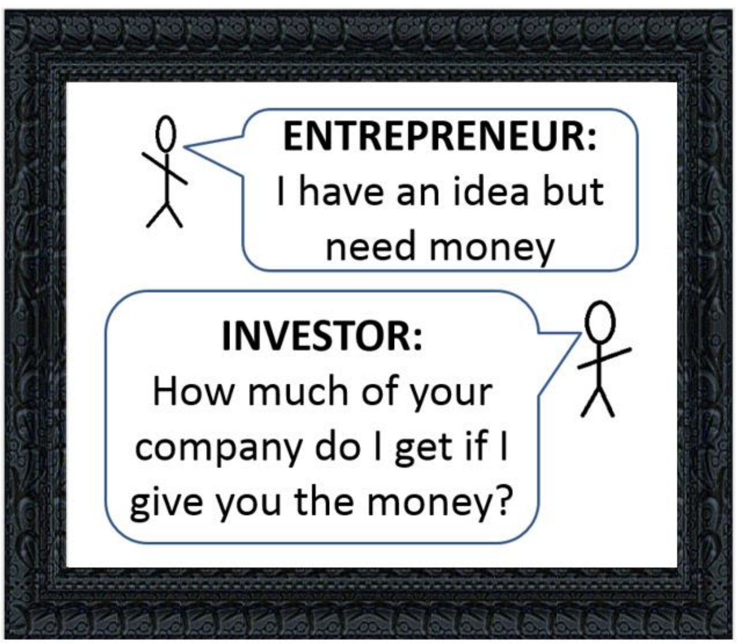
Capital structures as art

Dear Reader, I encourage you to consider capital structures as art, not as an obscure, technical thing that you need special expertise to consider.

I love art. I have an affinity for some forms. For instance, I particularly love sculpture, especially if it portrays realism or ideas. When inspired to do so, my father made such works, so I appreciate the skill, sensitivity and imagination that it requires. I appreciate paintings too. When I look at a piece in a museum, I step back. I shift my position. I get in close to sense technique, sometimes inches away, which surely strikes some who are around me as peculiar. I also read the placard to learn about the artist's time, place and life.

As a result, my accumulated sense of art, of history, and of human nature and experience itself is richer than if I experience pieces as mere objects. On occasion, this perspective gives me insight into matters that are wholly unrelated to art. That's because a broad base of reference points—dots, if you will—enables me to draw richer connections.

Here's an image that I want you to contemplate.



Note that this simple question suggests others such as, "What is the value of the company?" and "How might it be measured"?

Answer these questions and others emerge. Like "How likely is it that the answer is wrong?" And, if the odds of that are high, doesn't that cast the first two questions in a new light?

These questions, in turn, lead to another--"Might they decide later?" That is, once they have a better idea what the value is?

If so, that leads to another question, "What questions might that approach raise?"

How might you contemplate a capital structure? If you view it as art, Sister Wendy Beckett has a brilliant answer. Best known as Sister Wendy, she's a United Kingdom nun. She is also an art critic. Her views on art are in a series of programs on the BBC. In the U.S., the Public Broadcasting System (PBS) has a one too, "Sister Wendy's American Collection." Here's how she advises one to appreciate art.

> *I would tell them to go to a museum and look at no more than two or three works, perhaps even two or three taken at random.*
>
> *Look at them. Walk backwards and forwards between them.*
>
> *Go and have a cup of coffee. Come back again.*
>
> *Wander around the museum. Come back again.*
>
> *Go to the shop. Buy postcards of them.*
>
> *Look again, and go home.*
>
> *At home, look at the postcards. Borrow from the library books on these artists. Go back again.*
>
> *Eventually you will find they open up like one of those Japanese paper flowers in water.*
>
> *You have to expend time and energy. If you don't want to do that, you can still get a lot of enlightenment and entertainment by just wandering around, but you'll never get the deep spiritual nourishment.*[2]

If you invest time and energy to connect the dots in this book, in your experience and news reports, you'll form images that open up like a Japanese paper flower. You will view aspects of finance differently than you do now, especially if you assume the perspective of a public investor.

> "To see what is in front of one's nose needs a constant struggle."
>
> - George Orwell

You'll prepare yourself to ask other questions about a company's capital structure such as:

- How are voting rights allocated?
- Is stock-compensation spread broadly or concentrated in top management? Is it earned based on performance or on the passage of time?
- If there are unusual features in the capital structure, who benefits from them?
- Do deal attributes fit with the company's stage of development?
- IPO valuation—what does it say about how the company views public investors?

If you think about IPOs from the perspective of a public investor and you'll develop an intuitive sense for the Fairshare Model. Things may be hard to see when looked at from a familiar perspective, but when you look at them from a different angle, new aspects catch your attention.

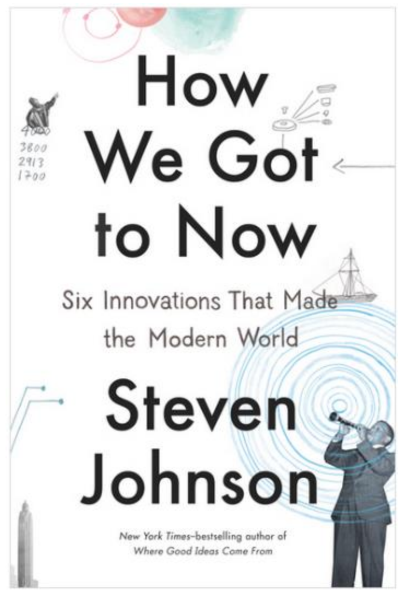
[2] http://www.pbs.org/wgbh/sisterwendy/meet/interview.html

Why capital structures deserve your attention

If you operate in the entrepreneurial sector of the economy, you spend more time contemplating capital structures than most. If you are not such a person, why should you care how about this?

First off, ultimately, capital structures reflect human behavior, which is fascinating. Detail can cloud this, but, step back from it and you'll see a world view expressed that anyone can assess.

Secondly, the pace of new company formation is associated positively with an inventive, adaptive society. Improving the opportunity for new things is good for the economy and makes life more interesting. In his 2014 book, *How We Got to Now*[3], Steven Johnson explores how inventiveness led to aspects of life that we now take for granted. Here are three examples:



1. Awareness that farsightedness or poor close-up vision was common resulted from the invention of the printing press. That's because people began to read more. Glassmakers learned to craft eyeglasses. Lens-making lead to telescopes, which made it possible for Galileo to conclude that Earth revolves around the sun. Conventional thinking, of course, was that the sun (and everything else) revolved around Earth.

2. Urbanization first lead to open waste in city streets. Sewers were invented to move sewage, but they contaminated water supplies with the bacteria that causes the deadly disease, Cholera. Discovery of how it spread led to water treatment technology that makes dense cities possible. Such technology also led to the ability to make ultrapure water, which is needed to make the electronics that define modern life.

3. The invention of air conditioning made it possible for vast areas in the southern U.S. to be comfortably habitable. Over time, older people, who tend to prefer warmth and who favor conservative politics, migrated to the southern and western states. Political maps were transformed as the result of air conditioning.

The dots that Johnson connects show how innovation in one area can ripple change elsewhere, altering society in ways in profound ways. He observes, "We make our ideas, and they make us in return."[4]

A question to contemplate. The Fairshare Model balances and aligns the interests of capital and labor. If it becomes popular, what changes might cause to it ripple in decades to come?

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[3] Johnson's book is the basis for a series on PBS http://video.pbs.org/program/how-we-got-now/

[4] "Just History, Not Common and Not Core: PBS's 'How We Got to Now' with Steven Johnson," Oct. 14, 2014, New York Times, http://www.nytimes.com/2014/10/15/arts/television/pbss-how-we-got-to-now-with-steven-johnson.html

Capital structures and sex

Dear Reader, if I haven't yet inspired you to explore capital structures, let me try a classic Madison Avenue strategy to get your interest. Sex. Seriously. It works for beer and cars!

Think about our popular understanding of capital formation now. If you were to ask people at random to define a capital structure or describe aspects of capital formation, it would likely resemble a person-on-the-street interview about sex and sexuality in the 1950s, before the dawn of the sexual revolution of the 1960s.

Back then, sex education comprised of a talk about "the birds and the bees", a name so indirect that it conveyed nothing. Some of what was understood was wrong-headed, based on ignorance, hearsay or bad research. The perspective of heterosexual males framed the entire matter. Female sexuality was largely an undiscovered country and homosexuality was a forbidden zone.

Think about where we are now, generally. Discussions are franker, information is better and perspectives are broader. Consider how life changed as a result of women asserting their interests. Look at how much has changed in the U.S. with respect to same-sex marriage. Marvel at how the Roman Catholic Church has evolved on the acceptance of gays and lesbians.

The point being, these changes are largely the result of *ideas*—not medical discovery or new technology—just a willingness to look at something familiar from a different perspective. Ideas can effect powerful change.

Capital formation is sex between a company and investors. Here, conception is valuation and its determination is routinely referred to as an "art." I've seen it called a "black art", which is as transparent as "the birds and the bees." Its determination is referred to in this manner for at least four reasons.

1. No one knows how to do it "right"—no method or process is clearly superior.
2. There is no intrinsic value to a start-up—the destination is as mythical as Camelot.
3. Valuation is relative; relative to what someone else might pay. That means valuation reflects opportunism (vs. intrinsic value), which isn't considered polite to discuss.
4. Dressing up valuation with mysticism inspires awe and discourages questions. Similarly, shamans rely on it when they proclaim how the stars, moon and sun foretell events.

Like romance, capital formation is rife with awkwardness: asking someone out or being asked out on a date is like an entrepreneur asking for support or an investor being asked to provide it. It is easier to talk about products, markets and management teams than valuation.

Most importantly, capital formation is about perspective. Assign the classic 1950s era male perspective on sexuality to companies and to accredited investors (a/k/a wealthy). Then assign the classic female perspective on sexuality from that period to unaccredited investors (a/k/a average). The point is that the needs of unaccredited investors are usually a secondary consideration when it comes to setting valuation.

Today, popular knowledge about capital formation is comparable to popular knowledge about sex in the 1950s. The precursors of the sexual revolution in the 1960s was information. Researchers like Alfred Kinsey, William Masters and Virginia Johnson broke ground by asking, from a medical perspective, "What is going on here?" Writers, musicians and filmmakers asked the question from a cultural perspective. Information and discussion converged into waves of change that profoundly altered social conventions.

In capital formation, similar enablers of change have been forming. Traditionally, college grads aspired to secure jobs in large companies but their allure has dimmed over the past two decades. It is now acceptable, even laudable, to plan to join or launch a start-up. Some even aspire to become venture capitalists, "The new superhero of the modern world."

Over the past fifteen years or so, angel investors have grown in number and organized themselves to an extent that would have been hard to imagine before that. Business incubators pepper the landscape. Companies have executives whose responsibility it is to encourage innovation. Universities have degrees in entrepreneurship, innovation and social networking. People from a range of backgrounds see business opportunities outside of large corporations, consulting firms and government. "Disruptive" has acquired a positive connotation; not long ago, it was principally associated with something undesirable.

In 1963, Bob Dylan released a song about the gathering winds of change, *The Times They Are A-Changin'*. The theme applies today. The Internet, social networks, innovative technologies and business models are bringing disruptive change to financial services—"Fintech" is the term used to describe it. Technology, in the form of the birth control pill, played a similarly powerful role in the sexual revolution.[5] In an essay in Time, Nancy Gibbs put it this way

> *The 1950s felt so safe and smug, the '60s so raw and raucous, the revolutions stacked one on top of another, in race relations, gender roles, generational conflict, the clash of church and state — so many values and vanities tossed on the bonfire, and no one had a concordance to explain why it was all happening at once. Thus did Woodstock, caked in muddy legend, become much more than a concert, and leaders become martyrs, and the pill become the Pill, the means by which women untied their aprons, scooped up their ambitions and marched eagerly into the new age.*[6]

Change is coming.

In capital markets, it feels like 1960, when the Pill was approved.

[5] The birth control pill was approved for use in 1960.
[6] Time, http://content.time.com/time/magazine/article/0,9171,1983884,00.html Nancy Gibbs is author of the book "Love, Sex, Freedom and the Paradox of the Pill: A Brief History of Birth Control"

Our ability to discuss sexuality has come a long way since the 1950s and the Fairshare Model is a call to get valuation out of the closet. The discussion that ensues will have ramifications for how companies are financed and how ownership interests are set.

Most people would agree that the women's movement has been good for men and for families, even when it posed challenges. A movement to promote the interests of public investors similarly promises to be good for entrepreneurs and society at large, even though there will be challenges.

Changes to the The-Way-Things-Are always have challenges. It has been observed that *change occurs when the pain associated with doing things differently is less than the pain of continuing to do it the way it's been done*. That suggests that public investors should channel Howard Beale—they should make their discontent known.

But, again, I propose positive energy to effect change in capital markets. Help develop a better way. Reformulate that observation to *change occurs when the advantage of doing things differently is greater than the challenge of doing it the same way.*

How can you do that?

- Talk about the Fairshare Model.
- Help identify ways to make it work in industries and communities that you care about.
- When companies adopt it, consider investing in them; be a supportive shareholder.

Capital formation is in a period of profound change, and this change will ripple into other parts of socio-economic life that affect you and people you care about.

So, even if you have little interest about capital formation now, this book will prepare you to engage in the lively discussions that lay ahead. How? Simply follow Sister Wendy's advice.

Take a look.

Walk away.

Come back.

Repeat.

Fairshare Model - The movie

Finally, Dear Reader, if I were to pitch the Fairshare Model to a movie producer, I'd need a simple story. A good one has a hero, a villain and a conflict. Here is what I would say.

The slumbering hero in this story is the Middle Class. For just over a century, she has been growing, coming into her own. Her quality of life steadily improved until the 1970s, when its foundations began to weaken. She has felt better at times, but her decline has progressed and it is now apparent to her that this has been happening. She feels anxious. The options deaden her spirit and dull her expectations for the future.

The conflict in this story is the lack of a promising solution. Our hero is of two minds. She can appeal to her community to change how resources are shared, but this creates discord. Or, she can find a solution herself. Her struggle is to re-discover her pluck, her optimism and ability to change the world around her.

The Fairshare Model covers an early part in the hero's journey, not the full story. Here, she learns that she has a latent power to shape capital markets by asserting her interests. Exercising this power has risks, however, and it requires her to develop new skills. The hero has self-doubts, but, the potential to overcome them energizes her spirit as she searches for how to use her developing power. Indeed, part of her optimism flows from the recognition that she may be able to help her entire community.

The villain in the story is The-Way-Things-Are-Done-Now, an immensely large and powerful ogre otherwise known as a conventional capital structure…but it has a key weakness.

The dramatic question is "What will she do?"

It may sound a bit crazy to use a Hollywood story line to describe a book about capital structures but I suspect that you'll come to agree that it is apt as you contemplate what's really going on, In particular once you read chapter four, "The Problem with a Conventional Capital Structure."

Onward

The next chapter delves deeper into the Fairshare Model using a question and answer format.

Chapter 3: Brief Question and Answer about the Fairshare Model

Preview

- Foreword
- What is a public offering?
- How expensive is a public offering?
- What is venture capital?
- What is a venture stage company?
- Is the Fairshare Model "crowdfunding"?
- What is a Capital Structure?
- What is a "class" of stock?
- "Investor Stock", "Performance Stock"…what are these names?
- What is a conventional capital structure?
- What does complexity contribute to a capital structure?
- Is a stock option that vests based on performance the equivalent of Performance Stock?
- How is performance defined and measured?
- Who gets the Performance Stock?
- Has the Fairshare Model (or anything like it) been used before?
- Do securities laws have to change to make the Fairshare Model legal?
- What is the attraction of the Fairshare Model for public investors?
- What kinds of companies might want to use the Fairshare Model?
- What is the attraction of the Fairshare Model for a company's private investors?
- What is the bargain between a Fairshare Model company and its investors?
- What is the bargain between the company and its workforce?
- How does a stock option compare to an interest in Performance Stock?
- How does restricted stock compare to an interest in Performance Stock?
- What challenges does the Fairshare Model face?
- Fairshare Model principles
- Onward

Foreword

The Fairshare Model is a Big Idea that is simple and intuitive in concept but it has a myriad of facets. So does a conventional capital structure, but few of us contemplate them because there has been no alternative to compare it to. The balance of this chapter briefly addresses questions that you, Dear Reader, may have before launching into the deep and occasionally meandering dive.

What is a public offering?

What constitutes a public offering in America? Oddly, the answer can be unclear, like whether a food product should be labeled "organic." In most cases, the answer is obvious but there are circumstances where regulators will find that a private offering is actually an illegal public offering or that a private offering causes an issuer to be subject to rules for a public company. Furthermore, issuers can legally sell stock to public investors in a way that some people feel isn't a "real public offering." For instance, some argue that an initial sale of stock to public investors is not a "real IPO" when the amount is below a given size and/or sold direct, without a broker-dealer. Securities law and practices are complex and some jargon fails to convey clear meaning. Therefore, "what is a public offering" can be slippery question to answer. Nonetheless, there are three basic characteristics.

First, a public offering has **disclosure requirements**; regulators seek to ensure that anything an investor ought to consider is disclosed. So, for example, financial statements and other disclosures are required. Private offerings have few disclosure requirements but investors must be accredited; public policy presumes that wealthy investors are smart enough to protect their interests. Some people assume that a public offering must meet a quality standard—that regulators only allow companies with good prospects to sell stock to the public. In truth, the U.S. Securities and Exchange Commission and many states enforce a disclosure standard. The presumption is that if a company clearly discloses sobering aspects of its business, investors will avoid it. A former SEC examiner told me "You can sell stock in a dead horse…so long as you disclose that it's dead!" Some states also apply their own "merit review" to evaluate the quality of an offering—their regulators might not allow stock in a dead horse to be sold to unaccredited investors who reside in their jurisdiction.

Second, securities offered in a public offering may be **legally sold to anyone in the U.S.** For that to happen, an offering must usually be registered with securities regulators or qualify for an exemption from registration. All major IPOs are registered---small offerings are more likely to rely on an exemption. Being exempt from registration can make the form of disclosure less expensive and rigorous for the issuer. For example, an offering that complies with Regulation A of the Securities Act of 1933 is exempt. Before June 2015, a Reg. A offering could be used raise up to $5 million. It can now be used to raise up to $50 million as a result of changes authorized by the JOBS Act to create a "Reg. A+" offering. In May 2016, another JOBS Act exemption from registration is in effect—the "equity crowdfunding" rule allows an issuer to sell up to $1 million a year in stock to average investors with less expensive disclosure requirements (e.g., financials need to be reviewed by an independent accountant but not audited).

Third, stock sold in a public offering can be **legally resold to anyone in the U.S**. Shares sold in a private offering may not be resold, at least not to non-accredited investors in the U.S. (it may be possible to resell them to an accredited investor or to an investor residing outside the U.S.). Now, the right to resell shares is different from the ability find a buyer; the market for shares in a small company can be minuscule. Additionally, stock sold by a company using the equity crowdfunding rule is subject to resale restrictions for one year after it is sold by the issuer. One might view a crowdfunding offering as a private offering that is open to anyone, where the shares morph into publically tradable ones. Some will say it is not a "real IPO" even if it literally is an issuer's "initial public offering."

How expensive is a public offering?

The cost of a public offering varies based on the complexity of the disclosures, the amount of money raised and how it will be sold. Companies that raise capital via a Wall Street IPO often spend millions for underwriters and substantial legal, accounting and printing fees, plus the expense of a "road show" for management to pitch their deal to large investors.

The Internet can greatly reduce this cost. The ability to reach investors directly enables an issuer to save selling expenses, which can run 6 to 15 percent of an offering. There may be little printing or travel expense. And, a new start-up can have simpler disclosure requirements because there is less to say. For such a company, the cost of a direct public offering to raise might begin at $25,000 for a small, newly formed company but $100,000 to $300,000 is a more likely range for start-ups that have operated for a few years when one considers legal, accounting, marketing and other up-front expenses. Associated costs of being a public (i.e., legal, accounting, audit, director & officer insurance, investor relations, etc.) can range from $300,000 to $800,000 per year. Many variables affect this and some of these expenses are incurred by private companies as well.

One thing is consistent, however, the cost and time it takes to find, engage and sell investors an offering is a significant challenge. That's why issuers hire broker-dealers; they have the names of, and relationships with, investors that issuers lack. They also provide comfort to investors in the form of due diligence and credibility. The biggest hurdle a company faces when it goes public without a broker-dealer is how to find, engage, and sell the offering to investors.

The greatest hindrance investors face is to gain comfort with an offering, including performing due diligence. The Fairshare Model can address the comfort challenge in a number of ways. First and foremost, an issuer that adopts it is confident in its ability to perform; the ability of employees to get tradable stock is tied to their performance. Second, a Fairshare Model issuer is likely to offer IPO investors meet the conversion criteria that they to investors.

As the number of investors who like the Fairshare Model grows, issuers will have an instant affinity group to present their deal to. If broker-dealers are engaged, they may charge less if such an affinity group makes their job easier.

What is venture capital?

Venture capital is popularly construed to be a private investment by wealthy private investors or funds, something that is too risky for public investors.

I define it more broadly; it's an investment in a venture-stage company, be it via a private or public offering. A foundational concept of the Fairshare Model is that capital provided to a venture-stage company is "venture capital" whether it is supplied by accredited investors or from public investors.

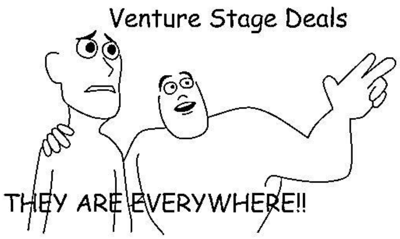
It's legal to raise venture capital in a public offering. It just wasn't popular with investors—it was viewed as too risky. That mindset began to change in the 1980s. Since then, it's no longer odd to see a venture-stage company raise venture capital via an IPO.

Instead of saying "you're drawing a distinction where there is no difference", a professor of mine used to say "same girl, different dress". Lady Gaga embodies that idea in the image below.

Some readers may prefer an image that conveys "same guy, different suit."

What is a venture stage company?

Such a company has the following risk factors:



- Market for its products/services is new/uncertain
- Unproven business model
- Uncertain timeline to profitable operations
- Negative cash flow from operations; ***it requires new money from investors to sustain itself.***
- Little or no sustainable competitive advantage
- Execution risk; team may not build value for investors

Many public companies list such risk factors in their offering documents and other regulatory, so, it's clear that **unaccredited investors have been public venture capitalists for decades!** So, one might ask, what's all the fuss about "equity crowdfunding?"

Is the Fairshare Model "crowdfunding"?

Not as you may understand it. In the U.S., the term "equity crowdfunding" is generally used to describe the sale of shares to public investors in an offering that is limited in size to one million dollars. Such an offering may be sold directly by an issuer, through a funding portal or a securities broker-dealer. It's a definition of limited usefulness because it suggests that crowdfunding should be a function of the offering size rather than how broadly shares are distributed.

I see equity crowdfunding as an innovation in *distribution.* That is, a new way to sell shares to public investors. The Fairshare Model is an innovation in the *structure or substance* of equity interests. An IPO that adopts the Fairshare Model can be distributed in *any* manner used by a conventional offering; it could be sold by broker-dealers or not; shares could be broadly distributed or sold only to large investors. These analogies make the distinction clearer.

- If highly processed food is conventional, fresh and healthy food is an innovation in substance and local farmer's markets are an innovation in distribution.
- Netflix began as an innovator in how movies are distributed; it delivered DVDs using the postal service versus stores. Internet streaming was another innovation in distribution. Now, it innovates in substance by creating original content, once the exclusive domain of studios.
- Tesla Motors innovates in substance (electric cars) and also seeks to innovate in distribution by selling directly to customers, outside the dealer franchise model that dominates the auto industry.

An issuer with a conventional capital structure that has an offering via one of the new crowdfunding portals is an innovator in distribution, much like convenience stores were innovators in how consumers bought consumables like milk. But whether it's sold in a convenience store (or a grocery store), in substance, its milk. Similarly, whether stock is sold via a crowdfunding portal (or a securities broker dealer), a conventional deal structure is a conventional deal structure.

Companies that adopt the Fairshare Model will likely use what's popularly known as an equity crowdfunding campaign because they are likely sell their shares directly to the public in what's known as a direct public offering (or DPO). The alternative is to hire a securities broker-dealer (i.e., investment bank) to sell the shares in what is referred to as an "underwritten offering."

A later chapter discusses crowdfunding at length.

What is a capital structure?

A capital structure defines how ownership interests of a company are ordered. A corporation's incorporation document—it's constitution, if you will—is an explicit statement of these rights.

The name of the document varies by where the corporation is formed or chartered; shareholders must approve changes to it. States vary in what they call the document—*articles of incorporation* is a common name. Should there be ligation on a matter that involves a shareholder matter, the lawsuit will be heard in the state that the company is incorporated in, even if it is based elsewhere.

How ownership interests are ordered depends on those who craft the terms. The state of incorporation may have general rules but, by and large, a capital structure reflects the interests of shareholders.

What is a "class" of stock?

When a company has a single type or class of stock, it's called common stock. Shareholders adopt the "*all for one and one for all"* motto from the novel *The Three Musketeers*, by Alexandre Dumas. Well, almost. All shareholders have the same rights but they are proportionate, based on how much stock they control.

When special rights are granted, a separate class of stock must be created for the shareholders who have them. As the number of classes increase, a capital structure becomes more complex. When some have special rights, one might say their shares are *un*common for their distinctive class is usually called preferred stock but it could be separate class of common stock. Different classes of stock enables groups of shareholders to be treated differently with respect to voting and economic benefits.

When there are multiple classes of stock, they will vary in their rank or seniority. All members of a class are treated alike but privileges or preferences vary by class. Think of a passenger ship; the quality of passage varies based on whether one is in first class, second class and so on. The senior classes may have superior ability to protect their interests if the ship is distressed. Classes of stock have similar effect.

Investor Stock and Performance Stock, what are these names?

The names are used to aid comprehension. Investors get tradable stock for money, the Investor Stock. Employees get Performance Stock for future performance. Performance Stock converts to Investor Stock based on the performance of the company. A company that adopts the Fairshare Model might refer to its common stock as "Investor Stock" and a class of preferred stock as "Performance Stock". Alternatively, it could have two classes of common stock (e.g., Class A and Class B).

What is a conventional capital structure?

In their book *Freakonomics*, Stephen Dubner and Steven Levitt write that famed economist John Kenneth Galbraith coined the term "conventional wisdom" to describe a convenient and comfortable point of view that is often false.

There is a conventional wisdom about how to organize the ownership interests in a corporation. It is enabled by a conventional capital structure (or model). One bit of conventional wisdom is the notion that a venture stage company should be valued substantially higher when it is public than when it is private. Metaphorically, that the "public venture capital Lady Gaga" a few pages back should be worth substantially more than the "private venture capital Lady Gaga." Another conventional notion is that public venture capital investors should not get price protection, even though private venture capital does.

> *A conventional deal deal structure is the nemesis of the Fairshare Model, which is decidedly unconventional with respect to IPO valuation.*

Conventional capital structures come in various forms but have three commonalities.

1. **A value for future performance must be set when a company issues new stock.**

Assume I sell you half of my new company for $1; we agree that my future performance is worth $1. Put another way:

My idea ($1) + Your money ($1) = Value of the company ($2) after your investment

The problem is that we don't know if my performance will be worth $1. It could be worth nothing, $0.05, $0.10, $0.50 or more than $1.00. Add zeros to the amounts to make it more realistic, the principle remains. A conventional capital structure demands that the parties set a value for future performance when the investment is made. This is hard to do in a reliable manner.

2. **Private VCs secure valuation protection in a private offering.**

When they invest, VCs mitigate the valuation problem; they don't buy the same class of stock that employees have. They demand that the company provide them with a class of stock that provides protection from an excessive valuation. Each investment round gets a unique class of stock. If there are four rounds of investment, the company will have five classes of stock: the one for employees and the four created for the investment rounds.

3. **Public VCs don't get valuation protection they invest.**

At IPO, the classes of stock held by a company's pre-IPO investors convert to the class that employees have (i.e., common stock), which is what new investors get too. This means the IPO investor buy must assign a value for future performance, commonality #1, without the safety net in commonality #2.

Convention is unfair to public VCs. What would be fair is capital structure that provides them with price protection that is comparable to what private VCs get. That's what the Fairshare Model provides.

Let's touch on how a conventional capital structure can manifest itself in public and private companies.

Conventional capital structures in public companies

Public companies tend to have a single class of stock. Multiple classes could provide equal rights for each class ("separate but equal") but usually grant super rights to some shareholders ("separate and unequal").

When Ford Motor Company went public in 1956, Henry Ford and other shareholders wanted to create wealth for themselves but also wanted to maintain control of the company. They accomplished this by adopting a dual-class common stock structure. A Class A common stock was sold to the public and a Class B super-voting common stock that was entitled to special dividend income was retained by the insiders. In 2010, the holders of the Class B stock held 2% of all the Ford shares but controlled 40% of the votes.[7] If that strikes you as unfair, consider that when it went public, Ford was well established as a profitable and growing company; there was no question about its ability to perform in the future.

When it went public in 2004, Google was an unprofitable challenger to dominant search companies so future performance was uncertain. Like Ford, Google adopted a dual class structure. It sold Class A stock to the public that has one vote per share while some pre-IPO shareholders got a Class B common stock that has 10 votes per share. LinkedIn, Groupon, Yelp, Zynga and Facebook followed with similar capital structures. Ever the innovator, Google, created Class C common shares in 2014 with no voting rights at all! I call it "silent partner stock" and it demonstrates the flexibility corporations have when setting their capital structure. By the way, in March 2014, Google's founders controlled more than 55% of the vote despite owning only 15% of the total shares.[8]

Conventional capital structures in private companies

Private companies with sophisticated investors nearly always have multiple classes of stock; employees get common stock and a class of preferred stock is issued to investors for each financing round.

The terms of the classes of preferred stock define their rights during ongoing operations and in future raises of private capital, liquidation or IPO. The terms are complex and the end-result may be counterintuitive. For example, early investors may be entitled to more proceeds than later investors who invest more due to liquidation preferences or dividend rights. Anti-dilution provisions provide price protection against having bought in at too high of a valuation; if the valuation in a later financing round is not high enough, earlier investors can get a retroactive reduction in their buy-in valuation.

When a company with such a capital structure is acquired or has an IPO, these terms determine how preferred shares convert into the common stock that is bought by the acquirer or registered to trade in the public market.

[7] http://www.forbes.com/sites/joannmuller/2010/12/02/ford-familys-stake-is-smaller-but-theyre-richer-and-remain-firmly-in-control/2/

[8] Financial Times, 4/2/14, "Google founders look to cement control with novel share split", by Richard Waters. http://www.ft.com/cms/s/0/5ba9a078-b9f2-11e3-a3ef-00144feabdc0.html#axzz37fGKPluL

What does complexity contribute to a capital structure?

A multi-class capital structure enables shareholders to be treated differently, which can be a good thing. Employees and investors have different interests; then too, there are differences in interests among employees (i.e., founders vs. non-founders) and among investors (i.e., early vs. later).

The downside of a complex capital structure is that it can be more difficult to assess the economic positions of the classes. That's because claims to a company's value is defined by the rights the classes, not their ownership percentage. Its easier to allocate positions when there is an IPO or an acquisition, though to do on an on-going basis.

The benefits of complexity outweigh the negatives. That's evident because some public companies use a complex capital structure to create preferences for certain shareholders and private investors routinely require them.

What's notable is that a multi-class structure is rarely, if ever, used to protect the interests of IPO investors. Why not? The reasons are explored in the next chapter, *The Problem with a Conventional Capital Structure*.

For now, consider this; the complexity presented by the Fairshare Model is designed to benefit IPO investors. The goal is stated in the first chapter—*to foster a self-renewing cycle for public venture capital, one that benefits entrepreneurs and both pre-IPO and IPO investors.*

Also, contemplate the transformation that occurs in the capital structure of a VC-backed private company at IPO. The preferred stock held by investors convert to the common stock held by employees based on their terms—this is also the stock IPO investors buy. Such a company would mimic the Fairshare Model if it did it the opposite way. That is, if it registered its *preferred stock* for trading and allowed its common shares to convert to preferred stock based on performance.

Is a stock option that vests based on performance the same as Performance Stock?

No. A stock option does not have voting rights, Performance Stock does.

How is performance defined and measured?

There is no short or uniform answer. There will be discussion about this question as interest in the Fairshare Model builds. It is an architectural concept, not an off-the-rack, one-size-fits-all blueprint; each adopter will decide how to engineer its application. How it is done will vary based on the issuer's industry, stage of development, strategy and culture. For instance, a life science company will define performance differently than one that makes software, food or a non-regulated product. There will be differences that reflect geographic sensibilities (i.e., Silicon Valley California vs. Silicon Wherever).[9]

[9] Under "List of places with 'Silicon' names" Wikipedia identifies more than two dozen monikers in the U.S. with a "Silicon" reference (Silicon Alley, Silicon Hills, etc.) It's popular in other parts of the world as well.

Who gets the Performance Stock?

Same answer as provided for the last question.

Has the Fairshare Model (or anything like it) been used before?

Not in a way that benefits average investors. However, the concept that underlies the Fairshare Model—price protection—is not new. In fact, it has been the bedrock of private deals for decades.

For example, when a VC or private equity investor likes a company, a foremost concern is that the buy-in valuation will turn out to be too high. Thus, they routinely require price protection; terms that retroactively reduce their share price if the company fails to perform as expected.

Acquirers—companies that purchase other companies—also rely on this concept, albeit in different forms. One is an earn-out clause, which allows a seller to get a higher price if the company performs well after it is acquired (i.e., price protection for the seller). Another form is a claw-back clause, which allows a buyer to recover some of the price agreed to at acquisition if the seller's company does not perform well enough.

So, the underlying idea of the Fairshare Model—price protection—is well accepted. What makes it novel, even radical, is that it extends the concept to average investors.

Do securities laws have to change to make the Fairshare Model legal?

No laws need to change. It would be helpful, though, if regulators require issuers to disclose and discuss the valuation that they give themselves in an offering. This would help investors be valuation-savvy and, over time, encourage issuers to offer better deals. Chapter 15, Valuation Disclosure, describes the importance of valuation disclosure and how you, Dear Reader, can express support for it.

What is the attraction of the Fairshare Model for public investors?

Companies that adopt the Fairshare Model are likely to offer IPO investors a relatively low valuation. This increases the likelihood of profit on an investment. It also helps investors maximize diversification in their venture portfolio, which can reduce portfolio risk (i.e., a given total investment can be spread over more companies). Furthermore, investors will know that an issuer's employees have high incentive to deliver the performance that will convert Performance Stock.

Potentially, Investor Stock will be less susceptible to nefarious "pump and dump" schemes by unethical promoters. This occurs when a stock, often a thinly traded one, is hyped on behalf of people with "free" stock they receive for services. Owners of Investor Stock pay the market price for their stock or earn it via performance. Either way, they truly invest. Thus, they may be inclined to hold shares for the long-term (i.e., not be a flip-oriented shareholder).

What kinds of companies might want to use the Fairshare Model?

Companies that seek an alternative to a VC for their next investment round and are willing to to do it via a public offering will have interest in the Fairshare Model. Some will have poor access to VCs, perhaps because of where they are located or their industry. Some will not like VC deal terms.

Companies who adopt the Fairshare Model will be confident in their ability to perform and sense advantage from having Performance Stock to attract and motivate employees. Their executives will be willing to offer public investors a low valuation in exchange for the opportunity to earn a high percentage of the Investor Stock. They will see benefit from using equity crowdfunding to market its products.

Chapter six describes types of companies likely to adopt the Fairshare Model. One is a company that hopes to be acquired once it completes product development. A version of this strategy was used by SmartThings. In 2012, it raised $1.2 million in rewards-based crowdfunding and leveraged this support to raise $16 million from VCs. In 2014, Samsung acquired SmartThings for $200 million. A similar course was charted by Oculus VR. In 2012, it raised $2.4 million in rewards and contribution based crowdfunding, then raised $91 million from VCs before being acquired by Facebook for $2 billion in 2014.

Undoubtedly, there will be companies that believe they can parlay an early IPO into a handsome gain for investors in such a manner. For them, the appeal of the Fairshare Model will be that insiders can have more control, and the opportunity to own a greater share of the wealth, than they would with VCs. Plus, they will be able to distribute equity among their early supporters.

What is the attraction of the Fairshare Model for a company's private investors?

Their company may be able to attract capital on better terms. If the company struggles after a VC round, odds are that the angel investor's position will be squeezed. Plus, their company may perform even better with the Performance Stock program! There is also the attraction of being able to sell shares; they can sell off enough to recovery their investment and hold the remaining shares as an upside.

What is the bargain between a Fairshare Model company and its investors?

If the company performs, investors will be diluted *on a percentage basis*—their slice of the ownership pie will be reduced. If the performance is good, they will experience heavy dilution.

On an economic basis, however, if the performance translates into a higher valuation, investors should not suffer dilution. In other words, investors have a smaller piece of a larger pie and the value of their piece is higher than their investment.

VCs like to say "I'd rather own a small slice of a big pie than a large slice of a small pie". Same principle.

What is the bargain between the company and its workforce?

In addition to regular compensation and stock options on its Investor Stock-- employees have an interest in its Performance Stock pool. As the team performs well enough to meet the conversion criteria, employees have another way to earn stock.

How does a stock option compare to an interest in Performance Stock?

Performance Stock is an issued security that votes. A stock option is a derivative instrument, not an issued security--it has no right to vote. It is simply the right to purchase shares at a set price in the future.

A Fairshare Model company can offer stock options on its tradable stock and they are more likely to have upside than conventional options. That's because its market valuation—the aggregate value of its Investor Stock—is likely to be low, relative to comparable companies that use a conventional capital structure.

Stock options are a powerful way to attract and motivate employees. They work best when employees believe that the value of the company will climb. Options from a company have little appeal if grantees feel it will take an Act of God to keep the stock at its current price, let alone increase it. Ironically, its in these circumstances that a company needs skilled, motivated employees the most. Put another way, options are less effective when the market says "Yes, we believe your company deserves a high valuation!" and prospective or existing employees see little upside valuation potential.

The valuation of such a company often falls. If it goes below the exercise price of options, they are worthless as an incentive or "underwater" in the argot of finance. If the lower value persists, companies often re-price the exercise price of options to create incentive. Investors may resent this because they can't reset the cost of their position, but valuable employees may leave unless their options are re-priced.

> Stock options are like a vehicle with only a forward gear (i.e., it can't go in reverse). They work if employees believe the stock will go up in the not too distant future; they don't work if a company needs to reset expectations for performance.

The key thing to consider here is that stock options create a direct connection between employee reward and something they have no control over—the stock price. The connection between reward and operational performance—which employees have control over—is indirect.

Granted, good operational performance should boost a stock's price but oftentimes valuations get ahead of actual performance. The so-called unicorns do this, and it also it happens with companies that might be dubbed horses or ponies.

Options train employee's attention more on the stock price than on operational performance. It is common for CEOs at companies with a soaring stock prices to urge employees to not get caught up in their apparent option-based wealth but to instead focus on achieving the performance that justifies the valuation. It is a hard message to get across. Partly, due to human nature but largely because the reward is tied more to the stock price than to operational performance.

With that understanding, Dear Reader, let us look at how stock options "vest." That word describes the means by which the employee secures the right to exercise the option to buy the stock at an old (and presumably lower) price.

By and large, most options vest based on time, say over three to five years of employment. Those that vest based on performance tend to be issued only to senior executives and the stock price is often a key indicator of performance.

Now, let's consider the question "How does a stock option compare to an interest in Performance Stock?"

- Performance Stock votes, stock options don't.
- Performance Stock can convert based on a rise in the price of the tradable stock, just like conventional options that vest based on performance.
- Performance Stock can convert based on operational factors such as revenue, profit, product releases, etc. Conventional options can vest this way too, but relatively few do.
- Performance Stock is more likely to be broadly distributed than options.
- Performance Stock creates a direct relationship between reward and performance for more employees than options do.
- Companies get stingy with options as they approach IPO or after they are public.[10] This leads them to pay more in salaries and benefits to inspire performance—the opposite of what investors want. By contrast, companies have reason to be generous with how they distribute Performance Stock after the IPO. When they are, employees are less likely to demand things that hurt the ability of the company to meet the performance goals.

The "secret sauce" of the Fairshare Model is its potential to help companies to out-compete others for employees, and to elicit coordinated, cooperative effort to achieve the goals that investors have.

To summarize, a Fairshare Model company can offer stock options that have more upside potential and something that conventional companies cannot--an interest in its Performance Stock. The share's value is like founder's stock—cheap. That's because its value is the ability to vote and its potential to convert based on performance. A company that uses the Fairshare Model can say to employees "If we, as a team, deliver the performance that our Investor Stockholders expect, you will get shares of Investor Stock". Beyond the financial incentive, there is the highly powerful appeal of joining a team of people who work with common purpose.

[10] Once public, they favor stock purchase programs that allow employees to purchase tradable stock at a discount from the market price which, again, focuses attention on stock price.

How does restricted stock compare to an interest in Performance Stock?

Restricted stock is stock that is issued—usually to executives—but cannot trade until the restrictions are released. Just as with stock option vesting, this may be a function of the passage of time or the achievement of performance goals. Voting rights are set on a case-by-case basis—there is no uniform answer.

To answer the question posed, let's assume the restricted shares enjoy full voting rights, that the shares are simply restricted from trading until they vest. In this way, there are similarities to these two methods to balance and align the interests of investors and employees. Both restricted stock and Performance Stock provide voting rights while denying liquidity until certain conditions are met.

How is Performance Stock different from restricted stock? There are three ways:

1. The timing of investor dilution for future performance differs. With restricted stock, investors buy-in up-front to a valuation that assumes the restrictions are removed. With the Fairshare Model, investors get buy-in valuation that does not assume future performance. When Performance Stock converts, the ownership of investors is reduced. However, if the performance leads to an increase in the market price of Investor Stock, investors might not suffer economic dilution as a result of the ownership dilution. The difference between a conventional capital structure with restricted stock and the Fairshare Model is when investors pay for performance. With restricted stock, they pay up front, based on the value of promised performance. With the Fairshare Model, they pay after performance is delivered.

2. Traditionally, restricted stock is only issued to senior executives. Interests in Performance Stock are likely to distributed more broadly.

3. Tone wise, there is a subtle difference. With restricted stock, the restrictions have to be removed for it to be tradable. For employees to have Investor Stock, it must be earned by meeting the conversion criteria. This difference may or may not be consequential, but there can be a difference in the psychological effect for those involved.

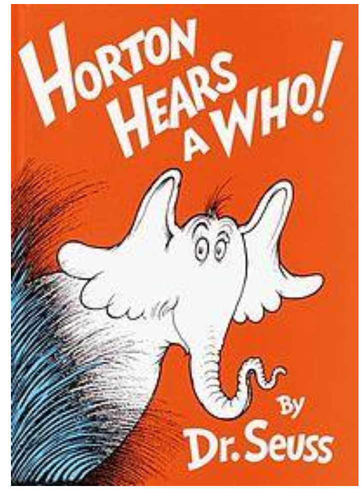
Another way to look at this is to realize that the two approaches have different purposes. Restricted stock plans attempt to solve a compensation and motivation challenge that companies have. The Fairshare Model has a different purpose—to create terms for public investors that are comparable to those that VCs get. The compensation consequences are a by-product of this purpose, not the main goal.

Therefore, if one were to consider this question just in terms of compensation, a case could be made that restricted stock is an alternative way to achieve that the Fairshare Model seeks to do. This argument breaks down, however, when one looks at the effect from the perspective of public investors.

What challenges does the Fairshare Model face?

Broadly, there are three phases of challenge for the Fairshare Model.

The initial one is to establish that there are many investors who would seriously look at investing in a company that adopts Fairshare Model. If you like it, know that BEFORE companies think about how to make the Fairshare Model work for them…



….A LOT of you need to make a little bit of noise….

…like, like, well…

…like the tiny residents of Whoville in Dr. Seuss's children's book *Horton Hears a Who!*[11]

With each of your small voices you need to create buzz. You can cause others to take note and join in.

People who like the Fairshare Model must combine their small voices and shout….

We Are Here!

We Are Here!

We Are Here!

We Are Here!!!

[11] The book tells the story of Horton the Elephant who hears a small speck of dust talking to him. He discovers that it is actually a tiny planet, home to a microscopic community called Whoville, where the Whos reside. The Mayor of Whoville asks Horton (who, though he cannot see them, can hear them with his large ears) to protect them from harm, which Horton agrees to do, because "even though you can't see or hear them at all, a person's a person, no matter how small." Other animals in the jungle ridicule for believing that there is anyone on that speck of dust because they are unable to see or hear them. The animals cage Horton and threaten to drop him in boiling oil if he does not drop the speck of dust into it. Horton tells the Whos that they need to make themselves heard to the other animals. The Whos accomplish this by **ensuring that all members of their society play their part in creating enough noise** to be heard by the other jungle folks. Convinced of the Whos' existence, Horton's neighbors vow to help him protect the tiny community.

The second challenge is to fine tune the Fairshare Model. This will be done by entrepreneurs, attorneys, angel investors and others with expertise in capital markets, corporate governance, compensation, tax and finance reporting. Many types of people will contribute.

The big questions that must be addressed are the "Ponderables", some which are listed below.

- How might performance be defined?
- Who should define performance?
- How might it be measured?
- Who should measure it?
- How should rewards of performance be allocated?
- Who should administer the rewards of performance?
- What are the tax and accounting implications of the Fairshare Model?

A conventional capital structure has Ponderables too

- Does it scale…*downward*? Its approach to valuation works for established companies but not well for venture-stage companies.
- Can the interests of investors and employees be better aligned as the valuation climbs?

The best answers to these questions will emerge from discussion, debate and experience with its innovative structure. Finding them will present beguiling questions about how to square human nature and the Fairshare Model. It will be a playground for researchers in decision science, behavioral finance and organizational development.

America's founding fathers engaged in similar discussion as the structure of government was debated. These pathfinders sought an alternative to dynastic, feudal forms of government. Their first product was the Articles of Confederation, which proved to have serious flaws—its strong state-model inhibited the ability of the states to function in a united form. The Federalist Papers, a series of pamphlets written by James Madison, Thomas Jefferson and John Jay fed public discourse on how to redefine the structure. In 1788, twelve years after the American Revolution, James Madison described the central challenge of defining a stronger central or federal government in this way.

But what is government itself, but the greatest of all reflections on human nature?

If men were angels, no government would be necessary.

If angels were to govern men, neither external nor internal controls on government would be necessary.

In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.[12]

[12] Number #51 of the Federalist Papers

Therefore, the third challenge for the Fairshare Model will be time and experience.

The product of the founder's deliberations was the U.S. Constitution. Yet, that didn't get it right, as witnessed by the number of times it was amended—*ten times before it was ratified* and more than thirty times since. One measure of how difficult is for people to come up with a set of durable rules that fits their needs and times is that there have been more than 11,500 amendments proposed to the U.S. Constitution since it was ratified by the Congress.

> The founders of the American experiment had admirable character and remarkable fortitude. The entrepreneurial teams that first adopt the Fairshare Model will surely have similar qualities.

Of course, that does not cover the challenge of applying a rule. Again, the U.S. Constitution is instructive. Over the years, there has been conflict over how to apply its meaning—as a strict constructionist or through interpretation of what the founders might intend, if they were presented with a contemporary situation.

For the Fairshare Model to gain widespread acceptance, pacts that are comparable to those between the government and the governed must be formed between investors (the providers of capital) and the providers of labor (management…and workers). It must make money for both—much more money than a conventional model.

Sustaining goodwill among these groups is **the central challenge** for companies that adopt the Fairshare Model. It will be harder for a large company, where the constituencies are far more diverse than for a start-up, where common interests are easy to identify. Early implementations of the model may reveal flaws it its approach to "government". If so, hopefully, fixes will be adopted in a manner similar to how the flaws of the Articles of Confederation were corrected by the Constitution, which was again repeatedly amended.

Again, there will be variations on the Fairshare Model, just as there are variations on a conventional capital structure and variation in how capitalism and democracy are practiced. Ultimately, it will present an ongoing laboratory to study human behavior and variations in organizational behavior.

Reaction from a prominent Silicon Valley securities attorney

I think your [Fairshare Model] concept is very interesting. My first reaction was, and still is, that it is not us (corporate and securities lawyers) whom you need to convince, but rather investors. Besides the investors you also then need to find the companies that want to be forerunners – always hard to find.

Everything in venture capital, or corporate finance for that matter, is about not re-inventing the wheel. Investors want stability more than new approaches. Further, venture capital as an investment class is not a very innovative industry in my mind. You find a lot of cookie cutter people out there who are even afraid to step outside a "normal" Delaware C-Corp capital structure, even where it makes sense. I think you may find more interests in hedge fund folks.

Anyway, very interesting work!

Fairshare Model principles

The five principles that guide the Fairshare Model are:

1. **Wealth Creation, Not Wealth Transfer**: Insiders don't become wealthy just because public investors supply the venture capital, rather, they become wealthy by delivering performance.
2. **Valuation**: Public investors get a deal that is similar to what pre-IPO investors get in a conventional IPO.
3. **Share Distribution**: The issuer allows a broad number of investors to buy shares at the IPO price.
4. **Control**: Voting control is equitably shared between investors and insiders.
5. **Incentive**: If they deliver the requisite performance, insiders can acquire most of the tradable shares.

Onward

The next chapter will discuss a conventional capital structure—the status quo—which has strengths as well as weaknesses. The weaknesses become apparent when applying it venture stage companies.

Chapter 4: The Problem with a Conventional Capital Structure

Preview

- Foreword
- Praise for a Conventional Capital Structure
- The Fundamental Problem: Valuation
- Private Investors Get a Valuation Cushion
- Public investors bear the weight of the fundamental problem
- You may ask yourself…
- The Next Guy Theory of Pricing
- Market Forces
    - Its considered “normal
    - Competitive market forces are weak.
    - Value Add
    - A bigger neighborhood
- Public investors bear the weight of the fundamental problem – Redux
    - Public investors have no price protection
    - The basis for an IPO valuation is speculative
    - Undemocratic allocation of IPO shares (which glues the other three risks)
    - Public investors have the most to lose from an excessive valuation
- Recap
- Bird’s-Eye View of Possible Outcomes: Conventional vs. Fairshare Model
- Onward

Foreword

Valuation is the Achilles’s Heel of a conventional capital structure. A conventional deal structure demands a valuation, but it’s difficult to arrive at a rational one. When the negotiating parties settle on one, it is fraught with uncertainty.

Private investors have ways to use a conventional capital structure to cushion themselves from the valuation conundrum. Public investors do not.

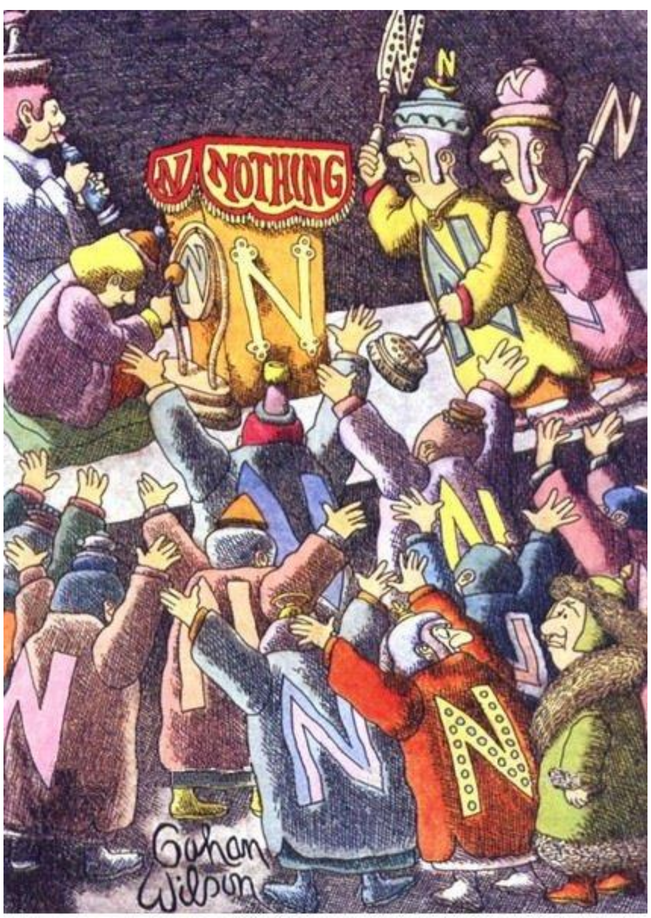
The best way to encourage reflective about the potential for innovation in capital markets is to talk about a conventional capital structure at its weakest point, which is how it affects public investors. This chapter does that for people inclined to defend The-Way-It-Is-Now. Its goal is to expose the belly of the beast, to spark discussion of the drivers of tradition in the relatively new market for public venture capital.

Praise for a Conventional Capital Structure

Before preparing to bury Caesar, let me first praise him. A conventional capital structure has numerous, substantial advantages:

- Proven over decades of use and applied in a range of situations;
- Simple to understand;
- Private investment funds are comfortable with the structure;
    - Of course, they know how to modify it (i.e., make it more complex) to protect their interests in a private offering;
    - It works better for professionally managed investment fund managers (i.e., VCs and PE funds) than for individual angel investors;
- It works, in the IPO market, but better for companies, for investment banks and investors they seek to curry favor with than for average investors;
- It's understood by service providers (i.e., legal, tax, accounting and valuation firms) who work for companies or investors;
- It's understood by stock analysts
- It's understood by securities regulators; and
- The media doesn't try to explain it because it's status quo.

Not bad for complex socio-economic process.



"Is nothing sacred?"

Cartoonist Gahan Wilson sets the tone for the balance of this chapter

The Fundamental Problem: Valuation

Praise aside, a conventional capital structure has a fundamental problem, an Achilles' heel. At the time of an equity financing, it requires the issuer and investors to set a value for future performance. For venture stage companies, this is hard to do in a rational manner.

You can test this assertion even if you are a novice about capital structures and valuation. When you meet someone who raised money for a company or who has invested in one, ask "What was the valuation?" Follow that with "Why does that make sense?"

> HorseConnect, The Social Network For Horses, Bought For $1 Billion
>
> *Source: The Onion*

Chances are that you will see uncertainty and anxiety play across their face. Why? It could be that they don't know what the valuation is. Perhaps, they know the number but not how to calculate it. Very possibly, they don't know how to evaluate it, or, they are not confident that it makes sense.

Still, a value must be set for future performance. This is the fundamental problem of a conventional capital structure—the need to settle a question before there is evidence of what the answer should be. I refer to it as the Achilles' heel because the Fairshare Model attacks the conventional structure, which is strong and seemingly impervious to injury. The "arrow" is embodied in how the Fairshare Model settles the performance question—it waits until there is evidence.

Valuation is what the parties agree the entire company is worth. If an investor wants to make a profit, they should pay attention to valuation because he/she only makes money when someone buys their stock for more than they paid for it.

> Slack's valuation in the $120 million round is based almost as much on speculation as on traditional metrics. "One billion is better than $800 million because it's the psychological threshold for potential customers, employees, and the press", the CEO said.
>
> - "How to get a $1 billion valuation in just eight months", Fortune, Jan. 22, 2015

The problem is that it is hard to determine, rationally, what the value of a company should be, especially if it is early-stage. Yet, a conventional capital structure demands one. That is the source of the uncertainty and anxiety; you have asked your conversation partner about something important that they may not understand well and/or can't justify in a sensible manner.

How hard is it to come up with a rational valuation? Imagine that you are required to assess a class of elementary school children for who will be a success in life. Define "success" any way you like. You have as much information as you want about the kids, so, you have clues that about who may achieve success. You struggle because you know that life is uncertain. It takes unpredictable turns. Qualities that will be important in each child's future may be unknown to you. Or, they may be difficult to assess.

> "It's tough to make predictions, especially about the future."
>
> — Yogi Berra

If you were actually forced to make this assessment, it would be hard. Time would reveal that you were wrong in many instances. The success of each child is difficult to predict reliably because, in reality, success does not lend itself to prediction. It reveals itself over time and with perspective.

Entrepreneurs and investors are similarly challenged when setting a valuation—but from different perspectives. Entrepreneurs think their future looks bright. Their backers clearly do too, but they don't know if the entrepreneur's confidence will be borne out. Even though the company's success will reveal itself over time, the players must set a valuation.

So, *the central problem* for a conventional capital structure is that it does not reflect the way life actually plays out. It requires a decision on something that is difficult to assess and that assessment is often wrong.

A derivative problem is the lack of transparency in valuation—neither the figure nor the rationalization for it is a required disclosure for issuers. Valuation is a material consideration for a savvy investor. The figure is largely arbitrary but there are many who profit by dressing it up in artificial mystery and complexity. The valuation section will further discuss this and make proposal for how policy makers can make valuation and the reason for the amount chosen transparent for average investors.

Private Investors Get a Valuation Cushion

When investing in a start-up company, institutional investors sidestep the valuation problem by demanding what are known as "anti-dilution provisions", a non-intuitive term that amounts to price protection. If later investors buy in at a higher valuation, all is well. If the valuation doesn't rise high enough, investors with price protection get additional shares for the money they initially put in. In other words, the valuation they initially bought in at is reduced retroactively: more shares for the same money means a lower price per share or valuation.

Sellers of goods and services often offer consumers price protection by offering to match another seller's price. It's an inducement to get buyers to buy from them instead of a competitor. The buyer knows they want the product/service because it is of use or value to them (economists call this "utility").

Investments are different. They don't have utility; you can't eat, wear or otherwise consume an investment. An investor invests with the expectation that what is acquired will appreciate in value. But, it's hard to know what a private company's value is unless and until there is a liquidity event (it's acquired or becomes publically traded).

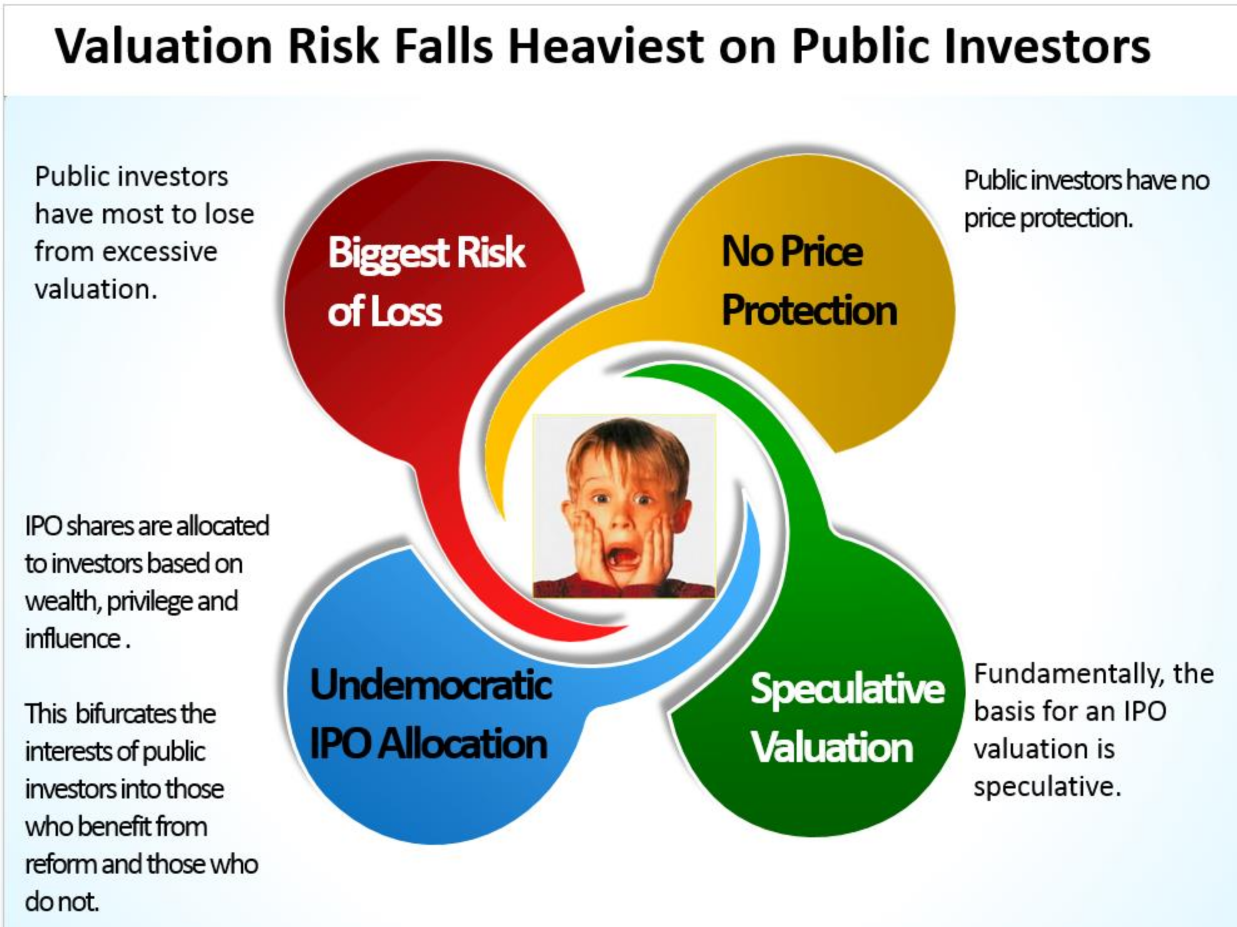
To induce a professional investor to buy-in at its valuation, companies must offer price protection. Put another way, VCs rely on more on price protection terms to avoid overpaying than they rely on their ability to identify the right valuation number.

So, for accredited investors, particularly professional ones, a conventional capital structure works well; they can reduce the risk of overpaying.

Public investors bear the weight of the fundamental problem

The weight of the valuation problem falls heaviest on public investors and it has four interlinked facets.

1. Public investors have no price protection
2. The basis for an IPO valuation is speculative
3. Undemocratic allocation of IPO shares (which glues the other three risks)
4. Public investors have the most to lose from an excessive valuation



These four facets are discussed at the end of the chapter. Before that, let's consider why the valuation problem falls heaviest on public investors when a company uses a conventional capital structure.

Two concepts explain why. The first is the Next Guy Theory of Pricing.

The second is that market forces in the capital markets are not strong enough to benefit public investors. If they were stronger, issuers would compete for public investors based on valuation and terms. That they don't compete is *prima facie* evidence of weak market forces in the IPO capital market.

You may ask yourself…

An IPO establishes a benchmark for a company's market value….but what does that value reflect when the company is a startup? It's performance? It's risk? More buyers to compete for shares? Less savvy buyers? A bit of all that?

Going public is not a controlled experiment on value. An IPO does not compare what wealthy pre-IPO investors feel the company is worth to what wealthy public investors feel it is worth.

A new, active ingredient is in the mix when a company has a public offering—average investors who have been unable to invest earlier. Their involvement effervesces the valuation for two reasons. First, they generally are valuation unaware. Second, they are enthusiastic, as it is their first opportunity to invest in the company. The dynamics of these factors creates demand that is relatively price insensitive—what economists call "price inelasticity"—for the supply of shares. Competition for shares by eager, valuation-unaware investors bids the valuation up from whatever the issuer decided to set it at to begin with.

Is there an intrinsic value for a venture-stage company?

If not, how about a "fair" value? One established by investors with relatively similar information and opportunity to invest?

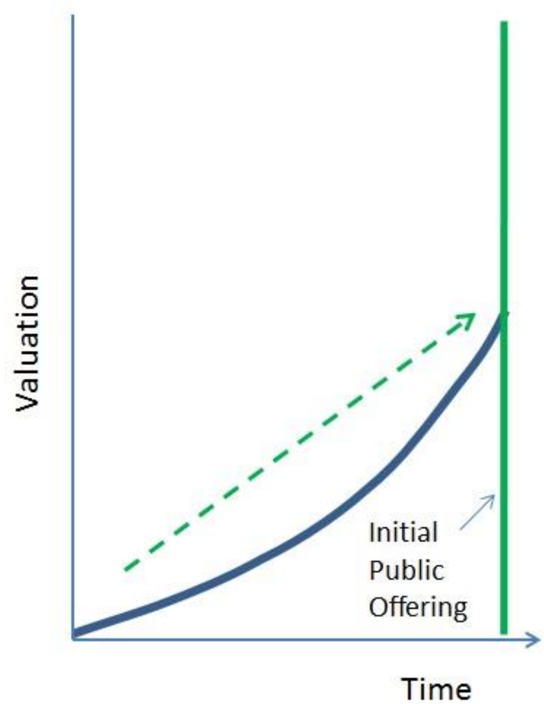
Is a company's value fairly measured in a private offering, where investors have price protection?

Is it fairly measured in the IPO or secondary market trading that immediately follows?

If each of these is a fair measure, what explains the remarkable increase in valuation that typically occurs in the quarters leading up to an IPO and then after?

You may ask yourself, is it performance or is it something else?

You may ask yourself…"How did I get here?" [13]



[13] With a nod and smile to the Talking Heads and their song "Once In A Lifetime".

The Next Guy Theory of Pricing

When explaining valuations to Fairshare members in the late 1990s, I described my Next Guy Theory of asset pricing. The economic climate has shifted over the ensuing years but the idea still makes sense and it doesn't require a fancy economic equation.

The Next Guy theory is that for an investment, the price is no more than what the buyer believes the Next Guy will pay, less a discount.

Expected Price a Future Buyer Will Pay	$ XXX
– Discount Required	(YYY)
= Price Present Buyer Willing to Pay for an Investment	$ ZZZ

So, if an investor believes the Next Guy will pay $10 per share and the buyer's minimal return is, say, 25%, the investor will pay no more than $7.50. I ignore the time value of money and the element of risk to focus on the principal driver —what the buyer-investor believes the Next Guy will pay.

The Next Guy Theory does not explain the price that a buyer will pay for necessities (food, medical, fuel, shelter, etc.), for pleasure (fashion, travel, entertainment), for a gift or for other non-investment purpose (vanity, status, guilt). These all have a possible combination of utility value, status value and emotional value. An investment rarely has these qualities.

The theory does explain buyer behavior when evaluating an investment. Consider real estate; the dominant determinant of price is whether the buyer believes he is getting a price that is lower than what someone will pay later. The buyer may have non-investment motivations; they need a place to live (consumption), they may love aspects of the property (pleasure) or other factors may be in play. But, if investment is the sole motivation, the price a rational buyer will pay for real estate will be a discount from what they expect the Next Guy will pay.

Ditto for cars, art, jewelry, although here, like in some investments, the concept of utility applies. You may, for example, be willing to pay more for something that reflects your social sensibilities, the image you want to project and so on.

For companies, the Next Guy theory explains why a rise in valuation isn't necessarily explained by performance. Instead, it's explained by who is doing the buying—public investors. Ergo, when measured by a conventional capital structure, valuation is a function of "who" is buying, not "what" is sold, as expressed in these concept equations.

Valuation = *f* [*Who* the investor is]

Valuation ≠ *f* [*What* the company's performance is]

Market Forces

The Next Guy valuation function explains pricing for investments, but it can also apply to products that have utility, like clothing or food, where wholesale/retail pricing models are used. Now, think about how the wholesale/retail concept applies to the venture capital market. Let's break down the components that you recognize in the trading in goods and reassemble them in a novel way. It will provide a new perspective about how market forces are neutered when it comes to capital formation.

So, what is the "product"? It is equity (stock) in a venture stage company, and, it is sold to investors in both the private and the public capital markets. Here, the "manufacturer" is the issuer and it sells its product to private investors at wholesale and to public investors at retail. As the prior chart illustrates, the rise in valuation as a company approaches an IPO can be substantial. So, comparable product, different pricing.

Wait! Check that last thought for a moment! The products are not comparable; they have important differences. The product sold at wholesale to pre-IPO investors, the institutional ones at least, is much better than the retail version. As described earlier, the stock that these investors get have price protection and other features. The product sold to public investors lacks such features. So, the retail buyer gets an *inferior product*…and *pays more* for it!

Can you think of another market—a competitive market—where that happens? I can't.

Take note of that last point, then, put it to the side. It's important, but it is a distraction from the big question. That is "What accounts for the increase in valuation of the manufacturer's (issuer's) product (equity) as it approaches an IPO?" The Next Guy Theory provides insight, but what are the drivers? What might be going on? Here are four hypotheses I've come up with.

1. Its considered normal
2. Competitive market forces are weak
3. Value add
4. A bigger neighborhood

Its considered "normal"

The first hypothesis is that everyone thinks its normal for a company's value to increase when is public. The ability to buy and sell ownership shares is a good reason why it should—it makes it easier and less expensive to attract future capital. But, "Do the reasons explain the scale of the increase?" Could it be that "normal" means "it happens all the time" as opposed to "it makes sense?" After all,

Many things that once were considered normal no longer are. Sometimes, because of new ideas. Sometimes, because those who were disadvantaged under the old norm assert their influence.

Competitive market forces are weak.

The second possible reason for the valuation rise is that *weak* market forces characterize the market for public venture capital. If competitive forces were strong, issuers would compete for investors by offering lower valuations. In virtually every sector of a vibrant, market-based based economy, where demand exceeds supply, sellers compete for buyers. *Why doesn't that happen in public venture capital?*

Young companies struggle to raise capital. There is high demand for it. And, there is a significant supply of investors with interest in such companies, as witnessed by their interest in IPOs. So, why don't companies routinely compete for public capital? Why don't entrepreneurs say "We're having a sale!" or "Our terms are better!"? I think the overarching reason is that *market forces are weak in the capital markets, insofar as public investors are concerned*. Nobody has incentive to compete in this way. Neither issuers nor investment banks do. And, public investors with the clout to change things actually benefit from The-Way-Things-Work-Now.

Issuers lack incentive to offer lower valuations because it reduces the wealth and control of its pre-IPO investors, including management. They view a discounted valuation the way that a cat views the prospect of a bath. They…well, um, resist. But, institutional VCs have the clout to break that resistance. When the pool of potential buyers is small, as it is for private offerings, these buyers decide what they think the Next Guy will pay and what the discount will be. Issuers can accept the deal offered or keep looking. On the other hand, in a public offering, the pool of buyers is large and none have as much clout as a VC in a private offering. The most powerful use their influence to secure shares that they can flip to the Next Guy…other public investors.

Investment bankers are uninterested in promoting competition for public capital because it complicates their business model. It's not easy to say "we represent the finest companies" then, turn around and say "this issuer has a better deal". Consumer brands face a similar dilemma with discounting but many have made "premium factory outlet stores" work. They sell discounted merchandise there while selling it at full price elsewhere. Something similar should work for broker-dealers.

So, issuers and broker-dealers lack incentive to compete for public investors based on deal terms. Surely, though, some would though if they felt there were was a large potential audience for such a pitch.

You might think that public investors who want better terms have to make some noise! But the investor who is willing to play sets the terms. Fact is, many investors are valuation-unaware—they don't know what constitutes a "deal." This problem has two components. First, one needs to know what the valuation is—many don't. Second, one needs a context to evaluate it. In real estate, it is easy to get comparable sales data, not so for stock offerings. You can help change that. Chapter fifteen describes how to let the SEC know that you support a valuation disclosure requirement for all stock offerings.

An additional solution is to reprogram the game, to change what is considered normal. Chapter eleven, The Tao of the Fairshare Model, describes the most intriguing aspect of the Fairshare Model; it provides issuers incentive to compete for investors by offering lower valuations.

As it gains acceptance, issuers with a conventional capital structure are likely to see public investors challenge their valuations. How might such companies respond? Some might adopt a variation of the advertising tag line used by a hair-coloring product—"L'Oreal. It costs more, but I'm worth it!"

Value Add

The third hypothesis is "value-add", which can explain most of the wholesale/retail price difference in many products. Wholesale buyers buy it in a more "raw" form than retail customers. To transform it to a "finished" state that retail customers expect, the product must be processed further. In this analogy, the issuer may need further development before it is presented to retail investors. Such work by the entrepreneurial team constitutes value-add. Since it is supported by and often guided by institutional VCs, some refer to this as a VC value-add.

It is easy to argue that a VC value-add exists. It's their guidance and network. Also, their ability to write large checks and attract other VC money. One challenge for companies that adopt the Fairshare Model is how to replicate the VC value add. To be clear, it is a challenge for issuers that adopt the model, not for the Fairshare Model itself. Similarly, a conventional capital structure was not first designed for VCs; it existed when the first wave of modern VCs were in college. Over time, they tweaked it. A similar phenomenon will occur with the Fairshare Model as it gains popularity.

Yes, it is easy to argue that a VC value-add exists but it is not easy to define it a manner that adequately explains the wholesale/retail valuation gap. Part of it may be due to performance, but what proportion? Part may be attributable to a celebrity effect. If Company ABC is backed by top VCs, retail investors are interested too. But they can't get allocations of IPO shares, they must buy in the secondary market. Some are like teenagers swooning over a chance to see the hottest heartthrob; their eagerness to invest surely contributes significantly to the gap.

A significant portion of the difference, I suspect, is not due to professional investor involvement. VCs differ in their abilities, plus, some do not create considerable value-add. Yet, the public virtually always pays a valuation premium. So, we're talking about a concept that's a bit nebulous.

Interestingly, I've seen investment bankers and other service providers boast that they "build value" because they help companies move from the wholesale to retail capital market. They don't make the company fundamentally better or less risky—they usher it into a different plane of valuation. It's a significant task in a number of respects, but the reward that they reap can be outsized. After all, they don't invent, design or manufacture the issuer's product, expand its market or they improve its operations. From an investor's perspective, the movement from private to public doesn't change a business any more than moving a caterpillar from one place to another makes it a butterfly—that transformation takes time.

Defenders of a conventional model may challenge this characterization, arguing that public investors only get to invest in the most promising companies—that private investors assume great risk by investing at an earlier stage and the sharp rise in valuation is their just due. While, I have respect for the value that seasoned, connected advisors can provide a company my counter argument is that the reduction in risk is a weak explanation for the scale of the rise in valuation; the increase is routinely disproportionate, hugely so.

A bigger neighborhood

What about that fourth possible reason? Does a bigger neighborhood influence valuation? I think so because investments such as real estate, art, etc. sell for more in areas with dense populations than those that are less so. Here's a conceptual equation for the idea.

More Potential Buyers = Higher Potential Demand = Higher Potential Price

A house or art in Peoria is not inherently worth more than in Chicago, but there are many more potential buyers in Chicago. And because those buyers imagine exposure to even more buyers when they are ready to sell down the road, the Next Guy Theory amplifies the present value of an investment beyond what buyers in Peoria have.

It is not stretch to imagine this phenomena playing out in securities as well. Moving from the private market to the public market is the inexact equivalent of moving a house or art from a small market to a big one. It is inexact because some public markets, like the NYSE and NASDAQ are attractive, and some, like the Pink Sheets are not. And the Pink Sheets, the backwater of the secondary markets, is where small cap stocks trade. Entering the public market may help explain a rise in valuation for venture-stage companies but it's a weak justification for it. A company that is hard to rationally value is exactly that, regardless of the market it is in.

From a **fundamental perspective**, the public/private valuation dichotomy presents a distinction where there is no difference. That is, the transition from private to public does not improve a company's revenue or profits. Neither does it reduce its overall risk. So, from a fundamental perspective, this conceptual equation is true.

Private Venture-Stage Company = Public Venture-Stage Company

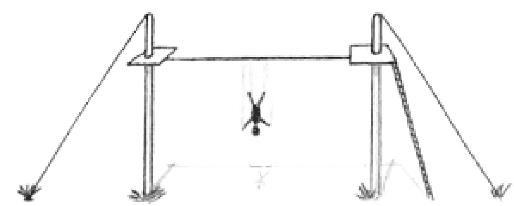
From a **market perspective**, however, a risky company that is public may be worth more than a similar private company. Intriguingly, the *entry into the public market* is associated with more value that being in the public market. This is why a private equity fund may take a company private by buying all its public shares. After a further investment to reinvigorate its performance potential, the PE firm will have an investment banker take it public again. The change in valuation is explained both by fundamentals (better performance) and a form of arbitrage between the two markets.

Public investors bear the weight of the fundamental problem – *Redux*

Earlier, I asserted that the weight of the valuation problem associated with venture stage companies falls heaviest on public investors. With both the Next Guy Theory and the weak market force argument in mind, let's revisit the four possible reasons that this is so.

Public investors have no price protection

A conventional capital structure has no price protection for public investors. If they overpay, they lose. Public investors pay more for undelivered performance than private investors. They don't have the type of price protection that professional pre-IPO investors get.



There is no Next Guy who will value undelivered performance highly. As the IPO fades in the rear view mirror, new investors will increasingly rely on actual performance. Therefore, public investors in a newly public stock bear the risk of overpaying in ways that other investors do not.

The basis for an IPO valuation is speculative

A conventional model demands a valuation for a company's future performance. It works for private investors because they get price protection on later investment rounds. Intellectually, it does not work for public investors. For them, in VC jargon, a conventional model "does not scale". That's because:

1. Techniques used to value a mature businesses don't work well for a venture-stage company;
2. Venture-stage companies are notoriously difficult to value using any other technique; and
3. Price protection is not available.

Therefore, a conventional capital structure is a valuation tool for public venture capital the way a hammer is a tool for a bolt. But practically speaking, it is the only deal on the menu. Issuers who adopt the Fairshare Model will offer a deal similar to what private investors get. Can a conventional capital structure be modified to do that? Perhaps, we'll find out if there is significant interest in the Fairshare Model. Until then, it is what it is, a tool that doesn't fit the need of public investors.

Undemocratic allocation of IPO shares (which glues the other three risks)

If IPO shares were allocated by lottery, democratically, if you will, I imagine that there would be calls from the most influential public investors (those who get allocations now) for a deal structure that was similar to those private VCs get. Various forms of protests by organized groups of buyers would apply pressure on issuers. Market forces in would cause things to change.

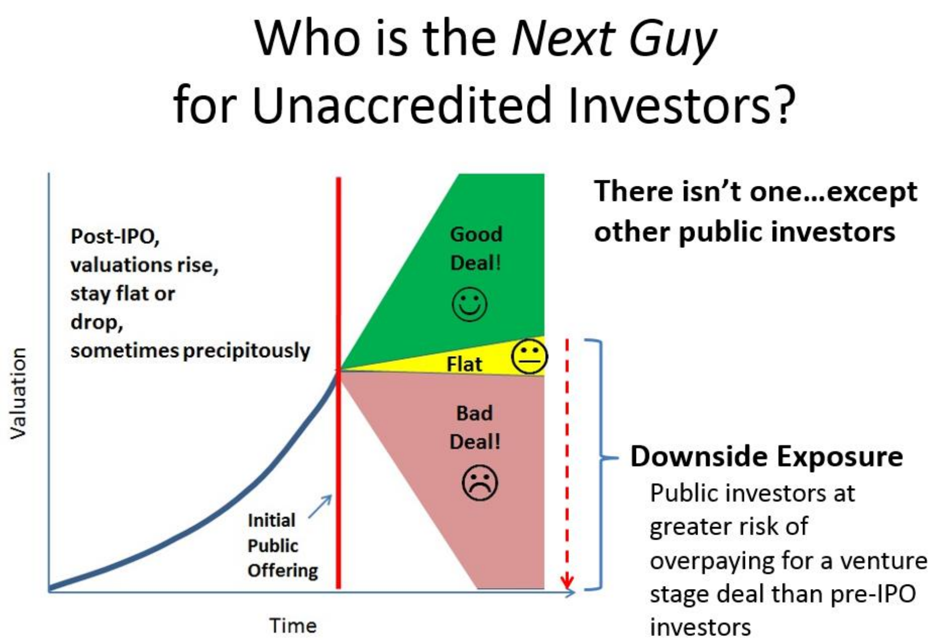
But, the interests of public investors are bifurcated. There are those who are favored by investment banks to get an allocation of shares at the IPO price because of their wealth, power and influence. Then, there is everyone else—and few of them are valuation-savvy. Neither group has had a voice on valuation but the first group doesn't care—they get in front of the second group when shares are allocated and then sell shares to them in the secondary market. So, the interests of public investors are in two camps, privileged IPO investors who may have an ephemeral desire to hold the stock and secondary market investors who are gleeful at the prospect of being able to invest.

In politics, high-minded rhetoric about the welfare of the population at large is routinely deployed. In reality though, politicians decide matters to appease their base of support and those with influence (i.e. campaign contributors). Is it farfetched to suspect that something similar happens in public venture capital? Might those with the influence to change the-way-it-works-now be the beneficiaries of the-way-it-works-now? Surely, defenders of the-way-it-works-now will reference the majesty of free markets. But, what if those forces are gamed in a way similar to how politics are? Would the uneven approach to valuation and other investor concerns be framed as a problem or a product of market forces?

Admittedly, this point is not a "risk" to public investors per se. But, it is a factor that glues the other three risks that I list, so, I include it.

Public investors have the most to lose from an excessive valuation

As the chart below shows, there is no Next Guy for the majority of public investors, the unaccredited ones. Thus, they collectively face the greatest risk that loss from an excessive valuation.



When performance expectations are not met, a stock is likely to drop. The loss may be absorbed by a large number of investors. An atomized loss, one spread over many investors, is not conspicuous, even to the victims of an excessive valuation. Indeed, most will view their loss as "just a bad bet". They don't realize that the fundamental premise of a conventional capital structure—that a valuation of future performance must be set when an equity transaction occurs—is flawed.

Recap

How durable is this situation? Time and time again, we see markets evolve as a result of sellers competing by offering buyers better value. Examples abound:

- Food and over the counter drugs: generic or private label vs. branded
- Books: Amazon vs. book stores
- Real Estate: web-listings vs. the Multi-Listing System limited to broker-dealers
- Clothing: designer knock-offs vs. designer labels
- Stores: Factory outlet vs. department stores, or, warehouse (Costco) vs. traditional retail

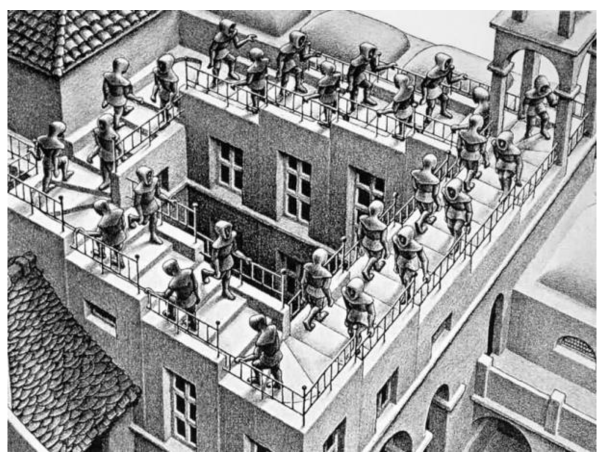
Warehouse clubs like Costco disrupted the consumer goods market by offering warehouse prices to the mass market.

The Fairshare Model is similarly disruptive because it encourages companies to offer IPO investors a "wholesale price," what private investors would pay for its stock.

Can a similar dynamic be applied to equity investments in venture-stage companies? It's likely, I think, if the SEC requires all issuers of equity securities to disclose their valuation and how they rationalize it.[14]

For public investors in a venture-stage company, a conventional capital structure has two essential problems. The basis for a high valuation is shaky, and, they assume most of the risk that it is too high. Four linked elements comprise the foundation for this problem.

1. Pubic investors pay "retail" for venture-stage investments but don't know it.
2. They are not offered a better deal because they don't demand it.
3. They don't demand it because they are not valuation savvy.
4. They aren't valuation savvy because securities regulators don't require valuation disclosure, and, companies see no benefit from stating what the valuation is and why they set it there.



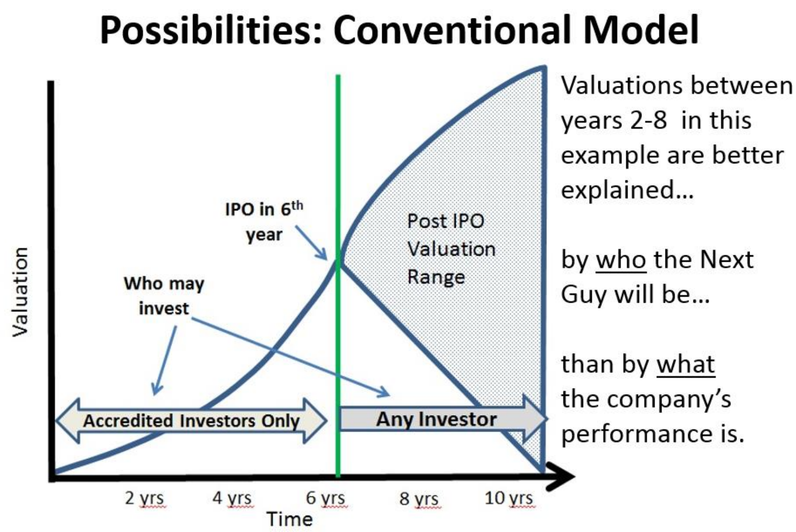
"So it goes", the novelist Kurt Vonnegutt might say.

I assert that the Fairshare Model is well suited for venture stage companies raising equity capital from public investors because it avoids the need to value future performance.

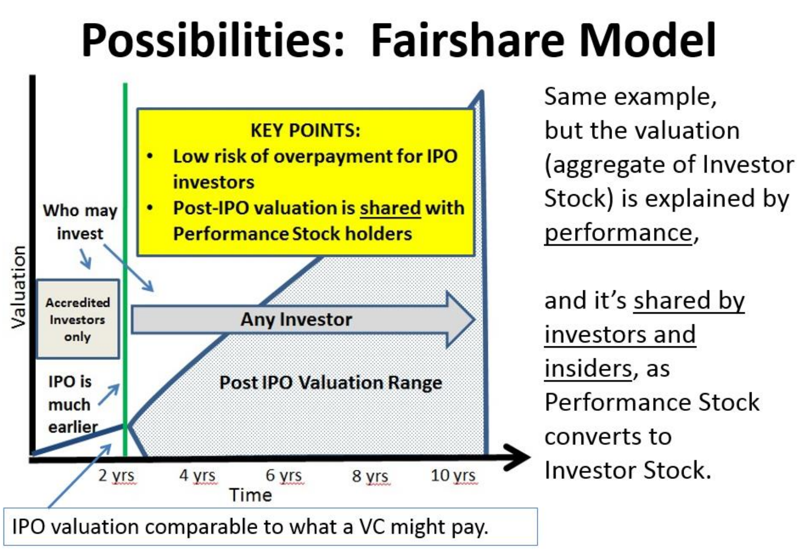
[14] More on this in chapter fifteen

Bird's-Eye View of Possible Outcomes: Conventional vs. Fairshare Model

Let's return to the charts from chapter one that show how public investors could be positioned in a conventional capital structure versus the Fairshare Model. The first illustrates the range of possible outcomes for public investors with a conventional capital structure. It assumes the issuer is backed by accredited investors until it goes public in year six. Until about year eight, its valuation reflects who the Next Guy is. After, it reflects how the company is performing.



The next chart illustrates how the Fairshare Model is different. Here, the issuer goes public sooner, in year two, at a much lower valuation. If it performs, the increase in valuation is shared by the investors and employees. If it doesn't perform, public investors will lose less because the IPO valuation was lower.



Onward

This chapter argues why public investors should be interested in upending tradition in public venture capital. Now that you learned about the Fairshare Model and its nemesis, a conventional capital structure, let's explore crowdfunding. That's a hot topic nowadays.

Thought Experiment

Imagine that, starting tomorrow, shares in Wall Street IPOs are allocated by lottery, not by wealth, privilege or connections.

Will investors who have routinely been able to get shares at the IPO price thus far be content with a conventional capital structure?

If, starting tomorrow, they have to buy shares in the secondary market (from those who win the lottery), might these well-connected investors clamor for a different approach to valuation?

Chapter 5: Crowdfunding and the Fairshare Model

Preview

- Foreword
- Crowdfunding is not a new idea
- Distribution vs. Structure
- Risky Deal Access vs. Risky Deal Quality
- The Drama -- in Opera!
- Self-Responsibility
- Registered vs. Unregistered Offerings
- Equity crowdfunding is not a totally new idea either
- Prospects for crowdfunding via Wall Street
- The Intermediary Problem for DPOs
- A role for intermediaries who are not broker-dealers?
- Perspective on intermediaries who are not broker-dealers
- Regulation of equity crowdfunding platforms
- Onward

NOTE: This chapter was written before October 2015, when the SEC released its crowdfunding rule that goes into effect May 2016.

Foreword

This chapter expands on my statement that the Fairshare Model is not equity crowdfunding as you know it. A key point will be the difference between an innovation in distribution and an innovation in structure.

It also provides some high-level perspective on the policy issues facing equity crowdfunding as envisioned by the JOBS Act.

It is an examination of tectonic fault lines, not a "how to" crowdfunding guide. The SEC final rules for the JOBS Act have not been released for comment—they are expected in 2015.

Crowdfunding is not a new idea

"Crowdfunding" seems new, but it isn't. It's been practiced for a long time in three forms: rewards, donation and credit.[15] Let's touch on examples of each before discussing equity crowdfunding.

In the early 1700s, Benjamin Franklin (yes, that one), wanted to start his own printing business but he didn't have the money to buy printing presses. The enterprising young man used **rewards-based crowdfunding;** he raised the money by offering the reward of future printing services at a discount. Rewards-based crowdfunding is used to raise money to develop a new product or service from supporters. In rewards-based crowdfunding, contributors receive no financial stake in the company's success, because they don't get stock. And, it's not money that is repaid if the product or service isn't produced or doesn't meet expectations. The incentive for someone to "invest" is part transactional (i.e., secure a deal) and part what fuels donation-based crowdfunding; the motivation mix will vary.

Donation—based crowdfunding is collecting money to support a cause or project. Clearly, it's been done for ages by groups of like-minded people. Intriguingly, the Statute of Liberty was the result of a donation-based crowdfunding campaign in France and the United States.

The Statue of Liberty was Crowdfunded!

The idea for a statue that would celebrate liberty was proposed by French writer Edouard de Laboulaye as he anticipated the centennial of the United States of America. He conceived it as a gift from the people of France to the people of the young nation. Enthused by the concept, sculptor Fredric-Auguste Bartholdi designed the potential statue and helped to promote building it.

In France, an organization named the French-American Union was formed in 1875 to raise money for the project. It was to be paid for by the French people, not by their national government, and the pedestal base would be paid for by the Americans. Over the following five years, tens of thousands of French citizens donated the money to build the statue.

In the U.S., it was hard to raise money for the statue's base. Leading newspapers, particularly the New York Times, often criticized the effort as folly and vehemently opposed spending any money on it. In 1885, newspaper publisher Joseph Pulitzer (yes, the one the Pulitzer Prize is named for), argued in his paper, New York World, that it was important to raise the $100,000 needed to complete the base for the statute.

> We must raise the money! The World is the people's paper, and now it appeals to the people to come forward and raise the money. The $250,000 that the making of the Statue cost was paid in by the masses of the French people- by the working men, the tradesmen, the shop girls, the artisans- by all, irrespective of class or condition. Let us respond in like manner. Let us not wait for the millionaires to give us this money. It is not a gift from the millionaires of France to the millionaires of America, but a gift of the whole people of France to the whole people of America.

Sources: Robert MacNamara's "Who Paid for the Statute of Liberty?" on About.com and the U.S. National Park Services website

[15] Tip of the hat to Kim Kaselionis, founder of Breakaway Funding, LLC (www.breakawayfunding.com) for pointing out the heritage of crowdfunding.

Credit—based crowdfunding is also an old practice, particularly in communities that have little or no access to affordable commercial lending. A popular variety is a group of people who contribute money to build a modest pool of capital that is available to help those with poor access to credit. The loans are often interest free—but borrowers are expected to repay the loan.

In the 1800's, Jonathan Swift, author of Gulliver's Travels, reportedly had such a fund for those suffering from the Irish potato famine. In the 1970's, Dr. Muhammad Yunus developed concepts for micro-credit lending and founded Grameen Bank to implement it in Bangladesh. He was awarded the Nobel Peace Prize for his pioneering work.

Non-institutional credit-based crowdfunding has been in place for generations where institutions are weak or expensive. Kiva.org has made more than a million micro-loans totaling more than half a billion dollars with a repayment rate of 99%.

Why would someone give money to such an effort? To fund a source of support for people who need it, of course, but there's more to it. It combines the altruism of donation-based crowdfunding with the satisfaction that one is getting something for it, a self-renewing resource that encourages the type of industrious activity that reduces the need for charity.

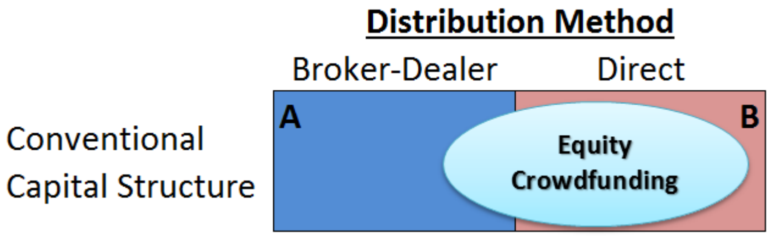
Now, let's take a detour to establish our bearings before discussing a fourth form of crowdfunding, "equity crowdfunding", which is an inexact term.

Before getting into that, we'll establish how the Fairshare Model is different from crowdfunding, and, why crowdfunding is controversial.

Distribution vs. Structure

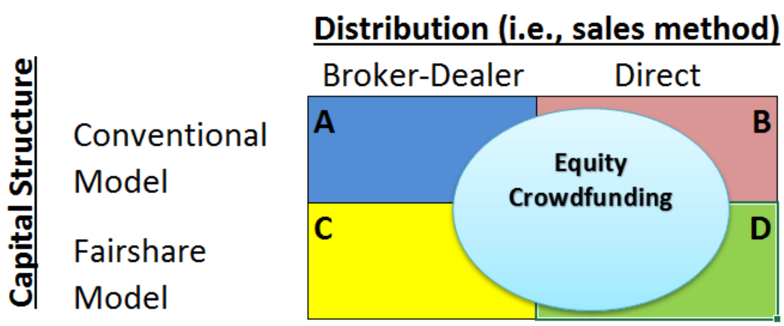
The Fairshare Model is not crowdfunding as you may understand it. Equity crowdfunding is an innovation in how shares are distributed (i.e., how new stock in a company is sold). On the other hand, the Fairshare Model is an innovation in how they are structured. What does that mean?

The chart below illustrates that there are two methods that a company can use to distribute its stock, hire a broker-dealer or sell it directly to investors. Equity crowdfunding is an innovation in distribution because it promises to make it easier for companies to sell stock.



There are two things to note. First, equity crowdfunding is a new way to sell a deal based on a conventional capital structure. That is, an offering in which a value must be placed on the issuer's future performance. Thus, it is likely to increase the exposure public investors have to overvalued companies—because setting the value involves a high degree of speculation. Second, equity crowdfunding can be used by broker-dealers. The box marked "A" indicates that the bulk of shares in underwritten IPOs will be distributed in the traditional manner but a portion might be crowdfunded. Box B similarly projects that most, but not all, DPOs will rely on crowdfunding.

The next chart adds the Fairshare Model and illustrates how is both distinct from and complementary with equity crowdfunding. It is an alternative structure for a public offering, regardless of how it is sold. Crowdfunding will make it easier to sell an offering and reduce the cost of capital, regardless of whether the shares are sold by a broker-dealer (boxes A and C) or directly by the issuer (boxes B and D).



Companies that adopt the Fairshare Model can sell shares via broker-dealers (box C) or directly (box D). Either way, they are likely to utilize equity crowdfunding.

Risky Deal Access vs. Risky Deal Quality

Virtually all debate about equity crowdfunding has centered on the wisdom of expanding access that young companies have to investors and vice versa. Let's add a new dimension—how to improve the quality of a risky deal that is sold to public investors. As you may recall from chapter one, that is my vision for the Fairshare Model.

Middle Class investors will be able to make venture capital investments
on terms comparable to those that professional investors get.

Crowdfunding enthusiasts embrace the first portion, that *Middle Class investors will be able to make venture capital investments;* they want it to be easier for companies to sell their stock to average investors. Of course, since the stock is based on a conventional capital structure, there is the valuation challenge.[16] There has been little discussion about how to deal with it.

On the other side of the debate, crowdfunding opponents fear that investors will lose money. They certainly will! Companies that use crowdfunding will be risky and have a high failure rate. But, rather than take the approach of early 20th century prohibitionists—outlaw alcoholic beverages—I suggest a different, less paternalistic tack.

Recognize that there are many legal ways for people to be foolish with money (i.e., lottery tickets, frivolous expenditures, casinos, etc.). Also, that there are plenty of smart, savvy, unaccredited investors who want to invest in young companies.

So, why not explore ways to make the risky activity less harmful? Advocate moderation and diversification to investors that want to invest in startups. Support investor education about deal terms. Urge the SEC to require that all issuers disclose and discuss their valuation in their prospectus (more on this in the valuation section). These actions may reduce the likelihood that investors will lose more than they can afford when buying stock in a conventional deal. And, of course, promote discussion about the Fairshare Model! Because an understanding of capital structures leads to more savvy decision-making.

Anyone interested in improving financial markets may have something to say about the second portion of my vision statement. The Fairshare Model is one way to accomplish it.

What other ideas are out there? Can a conventional deal be made "safer" for average investors? What other models should be considered?

[16] See chapter four, "The Problem with a Conventional Capital Structure."

The Drama -- in Opera!

So, as the preceding suggests, a drama is unfolding. Think of it as an opera. The opening is sung by a baritone voiced character who laments the poor state of the economy, the inadequate supply of jobs and rising income inequality. He declares that his search for a solution has led him to conclude that improving access to capital for entrepreneurial companies should help. His aria cites economic reports. For decades, he sings out, more jobs have been created by emerging growth companies than by Fortune 500 companies.[17]

All the other characters on stage nod and express enthusiasm for the idea. They sing as one glorious and coherent group. It's stirring.

Then, one calls out, "Where will the money come from?"

Cacophony ensues.

One calls out for tax incentives for the wealthy, but he is shouted down by others who sing out "no more, no more." Another cries out for government to use tax proceeds for the capital, but she too is shouted down by a different group who also sings out "no more, no more." Still another makes the case to allow small investors to step in but here, again, the clamor is loud, this time, the song is "not safe, too risky." Fading in and out between each of these group's cry is a chorus who laments for better, simpler days.

The question—"Where will the money come from?"—remains. If it is controversial for government or small investors to provide the capital, that means it is up to wealthy investors to do it. But that contributes to income inequality! After all, as one player points out, the return on venture capital investments has been attractive enough to attract a growing amount of capital.

Our opera ends with the characters agreeing on what they want. They write it on a poster.

As the lights slowly fade, the poster (box to the right) is raised for the audience to see.

They then sit down and wait, huddled in their respective groups, eyeing one another with suspicion.

WANTED

A way to supply capital to companies with promising prospects for growth and job creation that does not unduly favor the wealthy, does not require government support and does not carry high risk of loss of investment for small investors.

REWARD OFFERED

[17] In the 1984 movie *Amadeus*, the Austrian emperor presents Wolfgang Amadeus Mozart with a challenge. Compose an opera in German, rather than in the traditional language, Italian. Mozart questions whether German is mellifluous enough for opera, then accepts the commission. So, Dear Reader, be like Mozart; imagine that economic reports can be delivered in operatic form.

Self-Responsibility

That tongue-in-cheek opera simplifies the drama surrounding equity crowdfunding because this book is about the Fairshare Model, not the JOBS Act. The model does not need the JOBS Act, but, interest in it will surely rise with crowdfunding because the valuation problem of a conventional model—the need to set one for future performance—will become conspicuous to more people.[18]

Securities attorney William Carleton, frequently blogs about the JOBS Act. He feels that equity crowdfunding for unaccredited investors cannot be effectively implemented without a "re-do" to fix contradictions within the law that were created as the JOBS Act bill moved through the legislative process. Two solutions that he proposed to Representative Patrick McHenry of North Carolina, the originator of the bill, are in the scope of our discussion. They appear below.[19]

Investor protection

Create a bright line: "you are not allowed to lose more than this amount annually."

Propose that in any 12 month period, no investor is allowed to invest more than $1,000 in a single issuer, or more than $5,000 in equity crowdfunding deals in the aggregate. No need for a prospectus, audited financial statements, lawsuits against entrepreneurs, or other actions that are a burden or a threat to entrepreneurs.

Should anyone call for additional investor protections, knock a zero off the two investment limits. Make the single offering limit $100, and the annual aggregate limit $500. And then say, "if the experiment works at this modest level, we can consider increasing the levels in a few years."

There simply has to be an amount which reasonable people can agree are so modest that protections - which are a boon to lawyers but a tax on utility - are not worth their cost.

Entrepreneur protection

Put the onus of annual investment limit compliance on the investors. No need for entrepreneurs (or funding portals) to collect investor W-2s to verify income, then stress on how to meet privacy regulations.

Instead, require the investor to self-police. If she invests in excess of the limits, she is forever barred from bringing claims under the Securities Act against the entrepreneurs to whom she made false reps.

[18] The Fairshare Model could be used today in a Wall Street IPO—but early adopters are likely to be DPO issuers.
[19] "Does the U.S. Equity Crowdfunding Legislation Need a 'Do-over'?" by William Carleton, Crowdsourcing.org, http://www.crowdsourcing.org/editorial/does-the-us-equity-crowdfunding-legislation-need-a-do-over/19913

If regulators insist that investors may be confused by the responsibility, then require this mandatory disclosure:

> ***Prospective investors please note: you are likely to lose everything that you invest in this offering. Don't invest anything that you can't honestly regard as play money.***
>
> ***And it's even worse than that in the following respect: if we (the issuer) do something wrong, you can only go after us legally if you have kept your equity crowdfunding investment under the annual limits imposed by law.***
>
> ***It's not our job to police whether you have exceeded your annual limits. It's your job, and you exceed them at your peril.***

So, recall our opera. Some actors scoffed “not safe, too risky” at the idea of non-accredited investors to providing capital to entrepreneurs. Carleton speaks to their concern by combining a limit on investor exposure with an incentive for the investor to observe it. This a sensible approach to explore. Those who want to invest may do so. The risk is communicated starkly. Significantly, an investor loses legal remedies if s/he violates the limit, and, little legal or financial burden is placed on the parties (i.e., investor, issuer, broker-dealer or portal).

Securities law and regulation generally places the burden of determining investor suitability on the issuer and/or broker-dealer. The JOBS Act continues this tradition and makes portals similarly responsible. In the case of a private offering they are now expected to verify that an investor who claims to be accredited meets the criteria. Prior to the JOBS Act, issuers with a private offering could generally rely on an investor’s representation. In the case of ***private offerings exempt from registration*** (discussed next), issuers are required to enforce the limits that Carleton describes. This reflects a world view that companies should be responsible for investor behavior and, of course, there is a long history of people being duped in securities, that’s why they are regulated. But, there is also a long, deep history of people being duped to make *unwise expenditures that are not regulated*. My elderly mother, for example, spent an imprudent amount on overpriced gold coins after seeing television pitches about how they were a good investment. If TV networks were liable for disseminating misleading information, she would not have been induced to make such an unwise “investment.” But, it doesn’t work that way.

For ***public offerings exempt from registration*** (also explained next), the JOBS Act limits the amount an investor may invest in a given offering AND annually in similar offerings. It is difficult for anyone but the investor to monitor. Plus, any system to do this raises privacy and data security concerns. It is a dream for litigators and a nightmare for anyone interested in a reasoned approach to opening up capital markets. How to parse the responsibility between the issuer and investor is a key question. Policy makers must balance the risks associated with innovation and opportunity against the desire to protect average investors in a cost-efficient manner.

Carleton’s solution has a King Solomon-like line---*There simply has to be an (investment) amount which reasonable people can agree is so modest that protections are not worth their cost.*

I say, let’s find that amount and start to experiment!

Registered vs. Unregistered Offerings

Before completing our detour, let's distinguish a registered from an unregistered offering.[20] Opponents of equity crowdfunding don't want it to be easier for companies to sell stock in an *unregistered* offering but few oppose initiatives to make it easier for companies to sell a registered offering.

Some equity crowdfunding opponents may think that registration reduces *business risk*, but I don't see how. Registration increases disclosure. It doesn't mean that an offering earned a regulatory Good Housekeeping Seal of Approval; that doesn't happen. Nor, for example, does it reduce the risk that revenue will meet expectations. Some believe that registration disclosures ward off investors from an unwise investment. It does, provided an investor (or someone they pay attention to) reads and grasps the disclosures. The point is that a company with high business risk can register its offering. Now, under certain conditions, registration can reduce *liquidity risk* for existing shareholders because it enables them to sell their shares to other investors.

So, what is registration? Generally, to sell stock to U.S. investors, a company must register the offering with securities agencies with jurisdiction for those investors. The process requires an issuer to provide a registration statement that describes its business, the securities to be sold, has information about its management and audited financial statements. A portion of the registration statement is also known as the prospectus, offering document or selling document—it is what is typically provided to investors. It also may include material that is not in a prospectus, like major contracts.

Each state has a securities agency and there is, of course, the federal agency, the SEC. State securities laws are commonly known as Blue Sky Laws in the sense that they seek to protect investors from investments that resemble *an opportunity to own a piece of the blue sky above*, which is a poetic way to describe a fraudulent or highly speculative business proposition. There is little uniformity among blue sky laws even though about forty states utilize a shared model. So, each state has its own set of securities laws and its own review process. Same goes for other forms of law.

If a company plans to sell securities to investors in multiple states, it can simplify this process by registering its offering with the SEC. Under certain circumstances, the SEC has full authority over the registration statement; there is no state review.

Now, add a twist. Federal and state securities laws exempt (or excuse) certain types of offerings from their full registration requirements. When an exemption is relied upon, complications can arise. The chief one is that states need not accept the SEC review as the sole determinant of a lawful offering. That said, the principal federal exemption must be accepted by states. That's an offering that qualifies under Regulation D (a/k/a "Reg D") of the Securities Act of 1933 (a/k/a the Securities Act).[21] A Reg D offering may only be sold to a limited number of accredited investors. When angel investors, venture capital or private equity firms invest in a company, it's likely to be via a Reg D offering.

Okay, we're about to enter a zone of controversy. Some exempt offerings can be sold to unaccredited investors. This effectively makes the issuer public because investors have tradable stock.

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[20] I bow to Sara Hanks at CrowdCheck in appreciation for her insights. CrowdCheck (www.crowdcheck.com) provides due diligence and disclosure services for online alternative investments.

[21] One of the three Reg D exempt offerings (Rule 506) provides a federal exemption from registration that supersede state rules. The other two Reg D offerings (Rules 504 and 505) do not trump blue sky laws.

Why is this allowed? It is an effort by government to reduce the cost of raising capital for small issuers by simplifying or scaling down disclosures, a "mini-registration statement", if you will. For instance, an issuer may not be required to have audited financial statements. This experiment has taken various forms over recent decades but it hasn't been used to great effect. Why?

- First, there is an easier path for companies that only target accredited investors-- Reg D offerings have few restrictions and disclosure requirements, relative to an exempt offering that may be sold to unaccredited investors.

- Second, regardless of whether the offering is registered or exempt, a DPO issuer has the "intermediary problem", which we'll discuss in a few pages.

- Third, while federal securities law can trump state laws when an offering is registered, when a federal exemption is relied upon for an offering that can be sold to unaccredited investors, state law is not preempted. As a result, the process of clearing an exempt offering in multiple jurisdictions can be time consuming because states require adherence to their own law and their own review. An offering under Regulation A (a/k/a "Reg A") of the Securities Act is exempt from registration and it can be sold to unaccredited investors. It is a mini-registration both in substance and format. Title IV of the JOBS Act authorizes an increase in the allowed size from $5 million to $50 million (a so-called Reg A + offering), but it will not be effective until the SEC releases its rules on Title IV of the JOBS Act. In conjunction with the to-be-finalized Title III rules for equity crowdfunding, the Reg A+ offering will figure prominently in the modernization of capital formation.

Think back to that opera. Add a platform at the back of stage, so that some performers stand above the others and position the federal actors above state actors. All the earlier voices are there, but now the regulators are singing their aria in a discordant manner.

Granted, I take artistic license here. But consider how securities attorney Samuel Guzik describes the conflict between the federal and state regulators over the anticipated increase in the maximum size of a Reg A offering to from $5 million to $50 million.

> *Both the scope and breadth of the SEC's proposed rules appear to represent an opening salvo by the SEC in what is certain to be a fierce, long overdue battle between the Commission and state regulators, the SEC determined to reduce the burden of state regulation on capital formation—a burden falling disproportionately on small business—and state regulators seeking to preserve their autonomy to review securities offerings at the state level.*[22]

[22] "Regulation A+ Offerings—A New Era at the SEC", by Samuel S. Guzik, Harvard Law School Forum on Corporate Governance and Financial Regulation, http://blogs.law.harvard.edu/corpgov/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/

Equity crowdfunding is not a totally new idea either

Okay, detour done, what about "equity crowdfunding?" Surely, that's a new idea. It's what people get excited about when they contemplate new ways for companies sell stock online using websites such as Kickstarter, Indigogo, RocketHub, etc.

However, in my view, equity crowdfunding is not a new idea; it has been available for decades. It occurs when an issuer makes its stock available to average investors in modest amounts. Put another way, equity crowdfunding is an outcome, not a process. So, any new form of equity crowdfunding allowed under the JOBS Act is additional way to achieve an outcome that has been possible for years.

"Equity crowdfunding" is an outcome, not a process.

So what ways were available to make new shares of publically tradable stock available to average investors in modest amounts before the new law? A direct public offering (DPO) or an offering sold by a broker-dealer. Title III of the JOBS Act authorizes a third way—the use of online investor portals to facilitate the offer and sale of securities—that will make a DPO easier to sell. The law allows such platforms to be run by parties that are not broker-dealers, so long as they have oversight from FINRA or a new SRO. This is difficult for some regulators to support because traditionally, they have just had to police broker-dealers. Hence, equity crowdfunding as anticipated by the JOBS Act remains a chimera; there is no third way…yet.

Virtually all DPOs are crowdfunded. They tend to be undertaken by young companies whose offering size is relatively small (i.e. $7 million or less). A pre-Internet DPO pioneer was Real Goods Trading Corporation of Ukiah, California, a solar equipment retailer. In 1991, Real Goods raised $4.6 million in two direct public offerings by soliciting its mail order customers, winding up with 5,000 investors. The Internet era pioneer was Spring Street Brewing Company, a New York microbrewer. It's CEO, Andrew Klein, a former securities attorney, posted offering documents on the brewery's website and advertised it on six-packs. It raised $1.6 million from about 3,500 investors.[23]

[23] William K. Sjostrom, Jr., Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?

The second way to achieve equity crowdfunding is via an underwritten offering. But, as an idealistic entrepreneur discovered, Wall Street banks are not keen on giving average investors access to shares. In 1995, Boston Beer Company, maker of Samuel Adams beer, raised $75 million in an underwritten IPO. Founder James Koch said they had to overcome strong resistance from its investment banks and had to go through difficult regulatory hoops to make it possible for its customers to buy a few shares at the offering price (about an $500 investment). Here's what Koch told the New York Times.

> *You really have to fight the whole system: the investment bankers, the S.E.C., the current regulations,'' said Mr. Koch, noting that Goldman, Sachs, one of his underwriters, refused to handle the consumer deal. ''The entire regulatory system is not set up to allow shares to be available for consumers.''*[24]

Motivations for Equity Crowdfunding

Earlier, I described the motives for someone to provide money in each of the other three forms of crowdfunding—rewards, donation and credit.

The motive to provide money in equity crowdfunding is apparent, to own a stock that may go up in value. But it's possible that, in some instances, the motivation will have an altruistic element. For example, someone who buys stock in a company working on something that investors are willing to provide quasi-charitable support for (e.g., alternative energy, medical research, sustainable agricultural). It could also be that mainly want to support a management team they identify with because of who they are, where they are from or what they want to do. Indeed, equity crowdfunding could there could attract an exotic bird in the investment world—an investor who wants to provide support, have a voting rights…but doesn't care if they make money!

On the flip side, companies that are capable of attracting money via other forms of crowdfunding may be drawn to equity crowdfunding because it will enable them to offer a donor-investor an upside.

The motivation in the traditional channel for making investments—broker-dealers—is single dimensional. It's to buy low, sell high. Because equity crowdfunding allows for much smaller investments (from people who may not already have a brokerage account), it accommodates multidimensional motivations.

[24] "Boston Beer: The Sad Fall Of an I.P.O. Open to All"; by Reed Abelson, Nov. 24, 1996; New York Times, http://www.nytimes.com/1996/11/24/business/boston-beer-the-sad-fall-of-an-ipo-open-to-all.html?smid=pl-share

Prospects for crowdfunding via Wall Street

Have things changed in the 20 years ago since Boston Beer did a Wall Street version of "Fight the Power"?[25] Is it easier to crowdfund a significant portion of an underwritten IPO?

Koch said that the SEC and securities regulations were an obstacle to his crowdfunding effort. I can imagine why, but significant changes to securities regulations have taken place over the past two decades. The mindset of a number of regulators has been evolving. More change may well be called for, but, the most significant barrier to equity crowdfunding right now may come from the securities industry, not from government.

The SEC states that "it does not regulate the business decision of how IPO shares are allocated." A post on its website titled "Initial Public Offerings: Why Individuals Have Difficulty Getting Shares" makes the following points. [Note: the SEC's language is italicized; I add bold for emphasis.]

- ***Underwriters and the company*** *that issues the shares* **control the IPO process**
- *Most* ***underwriters target institutional or wealthy investors*** *in IPO distributions.*
- *Brokerage firms must consider if the IPO is appropriate for individual investors in light of their income and net worth, investment objectives, other securities holdings, risk tolerance, and other factors.* ***A firm may not sell IPO shares to an individual investor unless it has determined the investment is suitable*** *for that particular investor.*[26]
- *Even if the firm decides that an IPO is an appropriate investment for an individual investor, the brokerage firm may sell the IPO only to selected clients. For example, before you can purchase an IPO,* ***some firms require that you have a minimum cash balance in your account, are an active trader with the firm, or subscribe to one of their more expensive or "premium" services****. In addition,* ***some firms impose restrictions on investors who "flip" or sell their IPO shares*** *soon after the first day of trading to make a quick profit.*

So, if government doesn't hinder equity crowdfunding in Wall Street IPOs, what does? FINRA[27], the securities industry's self-regulating organization (SRO), may discourage broker-dealer (a/k/a underwriters) members from facilitating equity crowdfunding in a variety of ways. FINRA, not the SEC, sets investor suitability and other requirements to protect investors. These rules are also intended to reduce legal exposure from disgruntled investors.

A cynic might wonder if FINRA rules that hinder crowdfunding might also reflect a desire to protect the interests of the industry's most powerful players. After all, many of its decision-makers come out of

[25] The rap song "Fight the Power" by Public Enemy was used to conspicuous effect in the opening credits of Spike Lee's 1989 film, "Do The Right Thing." It's on YouTube http://youtu.be/U35MvblI4og

[26] Ironically, a broker-dealer might deem an investor unsuitable for an IPO allocation but allow the same investor to buy the same stock in the secondary market. From a cynical perspective, an unsuitability finding reinforces the prevailing Wall Street business model—position a firm's best customers to profit by moving them to the head of the allocation line. From an investor protection perspective, it shows how difficult it is to enforce suitability standards, after all, an investor could place a buy order with a firm that doesn't have one.

[27] FINRA is the Financial Industry Regulatory Authority, the SRO that resulted from the 2007 merger of the regulatory arms of the NYSE and the National Association of Securities Dealers (NASD). The NASD is no more, but the NASDAQ echoes its name; it is the acronym for National Association of Securities Dealers Automated Quotations.

the broker-dealer community itself. And, there is a duality to the nature of a SRO. On the one hand, it exists to keep government from directly regulating its industry. On the other hand, it acts like a trade guild, protecting the interests of its members. As discussed in "The Problem with a Conventional Capital Structure" chapter, the business models of investment banks rest on positioning their investor-clients to profit from buying the new shares of their issuer-clients. In other words, keeping *hoi polloi*[28] in back of the line to buy shares in a IPO appears to be the *raison d'être* (i.e., "reason for existence" in French) for Wall Street firms.[29]

But, let's suspend cynicism for a moment. Presume that FINRA, like the SEC, is neutral on how Wall Street firms distribute IPO shares. Boston Beer was conspicuous in its effort to crowdfund a significant portion of its IPO and other issuers have encountered similar resistance. So, what is going on here? Why don't we have more crowdfunding via Wall Street IPOs? Is it hard to do? Or, is it not in the interest of the underwriters?

Hmmm…investment banks have lots of resources; they routinely hire some of the brightest people and pay them humongous amounts of money. So, I'm guessing that the obstacle to crowdfunding isn't that it's just too hard to do. I'm going to go with the second choice—equity crowdfunding doesn't usually happen in a Wall Street IPO because its not in the interest of underwriters and they discourage issuers from pursuing it.

Thought Experiment

Which of these do you imagine is the most likely explanation for why an IPO sold by Wall Street underwriting firms is not partially crowdfunded?

A. Investment banks are frustrated because issuers routinely reject their recommendation to crowdfund a portion of their IPOs.

B. Crowdfunding a portion of an IPO is disadvantageous to an issuer.

C. Crowdfunding weakens the ability of investment banks to reward investor-clients who they want to curry favor with.

The times, they may be a-changing (a bit)!

In April 2015, Etsy, a New York based online marketplace for hobbyists and participants in the "maker's movement" had a Wall Street IPO that raised about $270 million. Etsy's management made sure that fifteen percent of the new shares were to investors who invested between $100 and $2,500. The distribution program was administered by Morgan Stanley and other broker-dealers.[30] So, Etsy crowdfunded a significant portion of its IPO with Wall Street banks. Bravo to all involved!

An infograph about Etsy's IPO is at the end of this chapter.

[28] *Hoi polloi* is an English expression derived from a Greek word that refers to the common people, the many, or "the unwashed masses." The Occupy Wall Street movement gave us "the 99%", which has the same meaning.
[29] Per Wikipedia, before 1860, most early U.S. corporations sold shares in themselves directly to the public without the aid of intermediaries like investment banks.
[30] "Etsy Vendors to Get a Piece of IPO", Michael Wursthorn, Wall Street Journal, Apr 13, 2015 http://on.wsj.com/1JOIMvc

The Intermediary Problem for DPOs

So, what are the prospects for equity crowdfunding? If it was economically beneficial for underwriters to do so, Wall Street banks would routinely crowdfund. If any of them felt it was the right thing to do, some might support issuers that want to do it. If there was requirement to do so, they would, but there isn't one, and, unaccredited investors are not organized to make that happen.[31]

So, if Wall Street investment banks are to support crowdfunding, it will be because issuers like Boston Beer Co. press them to. And if that is what we have to wait on, my forecast for crowdfunding via broker-dealers is "cloudy with a chance of disappointment." That's from the perspective of investors. The outlook is gloomier for small companies because they lack the clout of an issuer like Boston Beer.

What about DPOs? Issuers who sell shares directly to the public love crowdfunding. But, they can benefit from an intermediary, as can investors. When an intermediary can provide value, not having one is problem. There is an overarching problem, however; the opportunity for intermediaries who are not broker-dealers is often closed, narrow or uncertain.

The intermediary problem comes into focus as one compares the challenges faced by a DPO issuer to those faced by homeowners who tries to sell their house without a real estate broker-dealer. In both cases, the seller is unlikely to have a list of prospective buyers. Nonetheless, the seller must make potential buyers aware of their deal (i.e., a DPO or a home). In real estate, this is easier if buyers are looking in the neighborhood because, at any point, there will be just a few homes available. With a DPO, however, there's a sea of competition for a buyer's attention.

In real estate, buyers are reluctant to view a property for sale by owner. In securities, buyers may be reluctant to download and read a prospectus. In both cases, buyers may be reluctant to engage the seller directly in due diligence. In real estate, buyers often are under pressure buy (i.e., need a place to live or mortgage rates are going up). There is no comparable "need" to buy a stock.

The box shows a range of interactions where it is uncontroversial to use an intermediary. It is human nature to want one, even if we will decide what to do ourselves. They can make introductions, minimize awkwardness, plus, provide information and perspective on how to evaluate something.

Examples of Intermediation in Non-Regulated Transactions

Cars: third parties who review the design, performance and reliability of vehicles.

Colleges: websites that collect data on schools and suggest options to consider.

Services: rating services that compile measures of buyer satisfaction.

Dating: third parties who identify potential matches and facilitate communication.

Dining: websites and publications identify restaurants and review/rank them.

[31] As discussed in "The Problem with a Conventional Capital Structure", the interests of public investors are split between those who get IPO allocations and those who are not.

A role for intermediaries who are not broker-dealers?

Should parties who are not broker-dealers be allowed to *facilitate a securities offering*?[32] Put differently, should average investors be able to screen companies and share due diligence using websites that are not run by broker-dealers?[33] Or, put yet another way, for average investors, must the sole solution to the intermediary problem be broker-dealers?

This question is a large part of what the equity crowdfunding debate is all about. It asks whether society is best served by allowing new intermediaries help issuers sell their securities. If Wall Street IPOs were allocated in a democratic manner, the question would not interest so many people. If innovative companies were satisfied with the cost of raising capital, the question would not be as significant as it is.

If the answer to this question remains "no", the prospect for equity crowdfunding dims. That's because there is little reason to believe that Wall Street banks will alter their behavior. Also, because the intermediary problem that hinders the use of a DPO will persist.

Perspective on intermediaries who are not broker-dealers

For decades, accredited investors have joined together to educate themselves about investing, to screen deals and pool due diligence on them. The Band of Angels, possibly the first organized angel investor group, was formed by a dozen individuals in San Francisco in 1994. The popularity of this form of interaction grew. In 2000, the Keiretsu Forum was formed in the San Francisco Bay area to build on this concept.[34] Today, it is the world's largest angel investor network with more than 1,400 accredited investor members in 34 chapters. The growth in the number of such groups led to the formation of the Angel Capital Association in 2004; it has more than 160 angel groups and more than 7,000 investors.

Angel groups facilitate investments (i.e., make them easier). Before the JOBS Act, doing so risked violating securities regulations because they were not regulated. As a result, meetings routinely began with a benediction like this; "Nothing we discuss here is to be construed to be an offering of securities, which can only be made by a broker-dealer." Then, they went on to facilitate investments.

The need for this fan dance weakened in 2013, when the SEC announced JOBS Act rules that allow non-broker-dealers to facilitate investments by accredited investors online. Now, so-called angel investor portals may list private offerings, provide matchmaking services and facilitate due diligence. But, a portal may not charge success-based compensation. In order to do that, some affiliate with or become a broker-dealer.

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[32] *Facilis*, the Latin root of facilitate, means to make easy.

[33] Generally, attorneys, accountants and financial advisors are allowed to facilitate introductions and due diligence but this isn't a practical approach for average investors who want to invest a modest amount.

[34] *Keiretsu* is a Japanese term for a group of affiliated corporations with broad power and reach. Keiretsu Forum is a conglomeration of individuals or small companies that are organized around private equity funding for mutual benefit. Keiretsu Forum believes that through a holistic approach that includes interlocking relationships with partners and key resources, they can offer an association that produces high quality investment opportunities. [Source: http://www.keiretsuforum.com/about/]

For unaccredited investors, "investment clubs" provide similar benefits involving securities in the secondary market. The National Association of Investors Corporation—also known as www.BetterInvesting.org—has a membership of 50,000 individuals, most of who are in an investment club. Formed in 1951, the organization reached a peak membership of 400,000 in 1999. Investment clubs are like book clubs, but they discuss investing concepts and stocks. The Internet has reduced the appeal of formal investment clubs because there are many websites that provide education about investing and facilitate due diligence of stocks.

As the following anecdote illustrates, facilitation of direct public offerings is controversial. That's because it involves unaccredited investors, and, it does not fit cleanly in the regulatory framework.

A Peek Ahead to Chapter 7: Fairshare Model History & Projection

In the late 1990s, I was CEO of Fairshare, Inc., a company that planned to provide services similar to what angel groups provided, but our focus was on unaccredited investors and we delivered our services online. We offered three levels of membership; a charter membership was $99, a regular membership was $50 and an associate membership was free.

Fairshare offered education on valuation, deal terms and the Fairshare Model. We said that once we achieved a critical mass of members, we would let issuers who adopted the Fairshare Model submit their DPO for member due diligence. Those that passed could pitch their offering to our members for free, provided that members had the opportunity to invest to-be-determined small amount, like $100. Fairshare would charge no commission, nor handle anyone's stock or money. Basically, our plan was to offer services that angel investor groups did, but our focus was the average investor.

In 1998, a few months into our membership drive, the California Department of Corporations, the state's securities agency, issued a Cease and Desist Order that forbade Fairshare from offering memberships to California residents. The regulator has determined that a membership was a security, an investment contract. Since memberships were not registered as a security, we could not offer them. We appealed the finding but an administrative law judge upheld it.

The agency's website (www.dbo.ca.gov/ENF/decisions/) currently identifies the ruling as one of six "precedent decisions", which indicates its position on Fairshare memberships was both legally significant and likely to recur in a similar situation.

California's position is unique. Regulators in Texas, Ohio and Colorado also looked at Fairshare's program. When we discussed the California finding, each rejected the idea. Staff at the SEC also disagreed that a Fairshare membership was a security.

So, five regulatory agencies (four states plus SEC) see the same evidence. One finds that a Fairshare membership is a security and four don't. The 1994 movie *Forrest Gump* has a line that captures this situation—*Life's like a box of chocolates, you never know what you're going to get*.

Life is a learning experience and here is what I learned.[35]

- It is easy to create an investment contract in California. For a free Fairshare membership, all that was required was a name, address and email address. Our paid memberships promised nothing other than our best effort to do things that we said we might not be able to do (i.e., attract DPOs that met our criteria). Nowadays, the membership fee might be considered a form of reward-based or contribution-based crowdfunding…but probably not by the California securities agency, given the elevated status it gave its ruling on Fairshare memberships.

- Texas, Colorado and Ohio wanted to see Fairshare a regulated entity, not necessarily a broker-dealer. Our immediate services—investor education and community interaction—were not a problem. But, the services that we aspired to provide at an indeterminate future point—deal screening, shared due diligence and allocations of shares in DPOs—tested the boundaries of regulated and unregulated activity. When we created a subsidiary that was registered with the SEC as an investment adviser, their concern went away.

Regulation of equity crowdfunding platforms

Title III of the JOBS Act calls for a crowdfunding portal to belong to FINRA or another national securities association. In other words, the law requires them to operate under the umbrella of a regulatory authority. This is consistent with what Texas, Colorado and Ohio state regulators told me about Fairshare in the 1990s. In a backhanded way, its what California said when it found Fairshare memberships to be securities; it has the effect of requiring Fairshare to be a broker dealer or hiring a broker dealer to offer a membership.

So, the consensus among policy makers is that there is a possible role for non broker-dealers in facilitating DPOs. Now the question is, should the regulatory authority be FINRA or something else?

FINRA is a not-for-profit organization, not a government agency. Its website points out that it has 3,400 employees in 20 offices who oversee more than 4,100 securities firms with 640,000 brokers, so its large and well established. It is funded by the financial industry itself, not by tax dollars. Its member-firms pay membership fees, plus, FINRA also collects fines from members who violate its rules; it's website reports that it levied $75 million in fines and restitution from fraudulent traders in 2013.[36] The *argument for* requiring crowdfunding portals to be FINRA members rest on these robust capabilities.

[35] As Fairshare began its membership drive, I sent information about it to the SEC but received no response. About two years later, as chapter seven describes, I discussed the investment contract argument with SEC staff; they did not view a Fairshare membership as an investment contract.
[36] Restitution is collected by FINRA and paid out to investors who were harmed by FINRA members.

The *arguments against* FINRA as the regulatory authority crowdfunding portals include:

- FINRA has conflicts of interest as it is heavily influenced by Wall Street banks. It is therefore unlikely to manage oversight of crowdfunding portals in a way that allows them to threaten the interests of its powerful members.

- FINRA may smother crowdfunding portals with compliance demands designed for broker-dealers. They are different; the brokerage business is profitable and crowdfunding platforms may struggle to establish financial viability. Also, the average crowdfunding transaction size will be vastly smaller it is for FINRA members.

- FINRA regulators may handicap innovative crowdfunding business models because they don't "get" it (i.e., it's too different from what they normally see).[37]

- In industry, concentration of power often hinders competition, stifles innovation and leads to higher prices. Concentration of power in regulatory rulemaking and enforcement could have a comparable effect.

Two national associations have been formed in the U.S. for equity crowdfunding platforms; the Crowdfund Intermediary Regulatory Advocates (CFIRA) and Crowdfunding Professional Association (CfPA). They are small and lack financial viability but this could change when the SEC issues rules for crowdfunding platforms. That will allow companies to define business models and for these organizations to define membership fees that fit most models.

Another possible solution is for the SEC to provide *direct oversight* of crowdfunding portals. The agency already does this for Investment Advisers, who also have a national association, the Investment Adviser Association. The SEC's website describes them as "a variety of financial professionals provide services to help individuals manage their investments." For compensation, Investment Advisers advise others as to the value of securities and the advisability of buying or selling them. Investment advisers may include money managers, investment consultants, financial planners, general partners of hedge funds.

Whichever regulatory oversight path is selected, it is evident that the nascent industry will need more financial support than it can generate from membership fees. So, those charged with raising that support may be a bit like Blanche DuBois from Tennessee Williams's play *A Streetcar Named Desire*. She has the memorable line---"*I have always depended on the kindness of strangers*." The strangers for a crowdfunding SRO will be in the form of sponsorship deals from FINRA, the Investment Adviser Association, companies in the financial services sector and angel investor groups.

Equity crowdfunding platforms have the potential to disrupt the financial services industry the way that Walmart altered the retail business and Charles Schwab redefined the brokerage business. It will take at least a decade for the experiment to play out.

[37] Dividend Reinvestment Plans (DRIPs) are a way for shareholders to buy additional stock directly from the company, without a broker-dealer. This type of programs is nearly a century old. Thought experiment: If DRIPs were a new idea, would FINRA promote or hinder it?

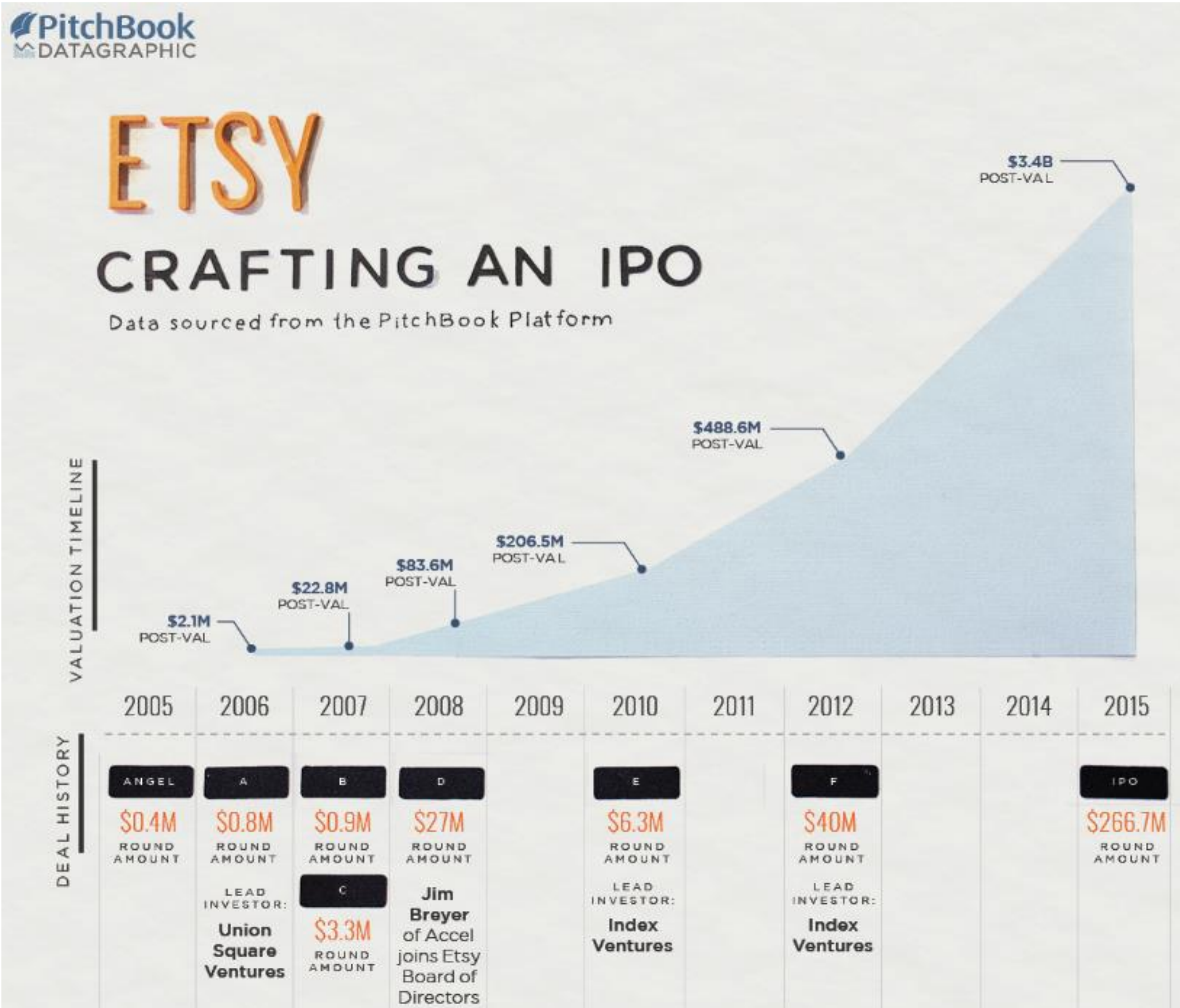
A word about Etsy

A recent development occurred that is relevant to this chapter—a Wall Street IPO had a significant crowdfunding element. In April 2015, Etsy, a New York based online marketplace for handmade goods raised $270 million in a Wall Street IPO underwritten by leading firms like Goldman Sachs and Morgan Stanley. According to its website, the company, which started ten years earlier seeks to “reimagine commerce—a transformation of every aspect of how goods are made, bought and sold.”

Etsy allocated fifteen percent of its IPO shares to small investors, many of whom are customers or suppliers. That qualifies as equity crowdfunding; a significant portion of the new shares are available to average investors. It is remarkable that the Wall Street banks selling the shares agreed to this plan of distribution, as it cuts against their business model. Morgan Stanley even waived conventional fees for new customers who invested between $100 and $1,500.

Etsy saw benefit from marketing via the distribution of its equity —it relies on favorable word-of-mouth to capture new users and spur loyalty. The investment banks saw benefit too. First and foremost, their client had smart reasons for wanting it. Secondarily, it reflects sensitivity to sentiments about income inequality and willingness to experiment with crowdfunding, a market that many broker-dealers are curious about. All of this is a good thing. And if Etsy’s experience is positive, we can expect more Wall Street IPOs to include a crowdfunding element. The initial reaction was good; Etsy’s stock doubled from the $16 offering price to $32 in early trading. It will take a while to assess more fully.

Below is a truncated version of an infograph about Etsy's financing history from Pitchbook Data. The full-version is viewable here https://my.pitchbook.com/s/lCItW1



Dear Reader, do you recall the charts in chapter one? The ones in the Bird's Eye View of the Thesis section. This valuation curve resembles the basic one there. It rises remarkably in anticipation of an IPO. There is little in Etsy's history to suggest that performance is the principal driver of the climb—it continues to lose money. But that's often the case with tech start-ups. Etsy simply provides an example of the Next Guy theory at work.

Onward

Having discussed the Fairshare Model, conventional capital structures and crowdfunding, the next chapter will speculate on to the categories of companies may be attracted to the Fairshare Model…if enough people make it clear that they like the model.

Chapter 6: Target Companies for the Fairshare Model

Preview

- Foreword
- **The Appeal of the Fairshare Model**
- **Common Qualities**
- **Categories of Companies-Overview**
    - **Feeders (a strategic category)**
        - Sidebar on the Cost of Being a Public Company
    - Aspirants (a strategic category)
    - Pop-Ups (a non-strategic category)
    - Spin-Outs (non-strategic category)
    - Rejuvinators (non-strategic category)
- **Possible Variants**
- **Can One Tell What Category a Company Is?**
- Onward

Foreword

What type of companies might adopt the Fairshare Model? This chapter contemplates five categories of companies that are likely candidates.

The Appeal of the Fairshare Model

As chapter four discussed, a conventional capital structure has strengths but it is beset with the valuation-related challenge. Increased awareness among public investors that they are the Next Guy for dicey IPO valuations is sure to create interest in an alternative approach, one that offers them a better deal. So, aside from public investors who are dissatisfied with their opportunities to invest in venture-stage companies, who else might like the Fairshare Model? What kind of companies might consider adopting it?

- Companies with poor access to professional venture capital.
- Companies who are unhappy with the deal structures offered by VCs or private equity funds.
- Companies who seek a competitive advantage to build and manage human capital
- Those whose management is attracted to the sensibilities of the Fairshare Model.

Common Qualities

Entrepreneurs who adopt the Fairshare Model for their company will share some qualities.

Surely, they will be confident that they can deliver the performance that investors expect. Those without such confidence are unlikely to adopt a capital structure that ties their wealth to performance. Possibly, the team will be *overly* confident; confidence is good, but no guarantee for investors. But would you rather invest in an overly confident company using a conventional capital structure or one that is willing to adopt the Fairshare Model?

Of course, those that choose the Fairshare Model may include companies that have trouble attracting capital. But that may be true for any public offering, regardless of whether the Fairshare Model or a conventional capital structure is used.

Some believe that a company that seeks capital from (unsophisticated) unaccredited investors is, by definition, *desperate*. That's because there is thought to be an abundance of (sophisticated) private capital available.

There is a measure of truth to this. Management at a company that has trouble raising capital is likely to be desperate. No money means no expansion, failure to launch, contraction or even demise.[38] The pressure may lead them to overstate their prospects or to understate or omit negative information in their offering documents. Securities regulators seek to minimize this, but no system is perfect.

Many, if not most, venture stage companies are *desperate for capital* at some point—even those with VC backing. That's because all such companies depend on outside capital—they do not generate enough cash from operations to sustain operations. And yes, there are VC-backed companies that struggle to find investors for a subsequent round. Some are desperate squared; desperate for capital and desperate to avoid a down round.

So, it's haughty and provincial to dismissively paint all companies that try to raise venture capital in a public offering as "desperate." It presumes that private capital is efficient in the sense that entrepreneurs with attractive opportunities find the capital needed. Geographically, that's untrue—VCs favor opportunities that ae near their office because there are many demands on their time. Industry wise, that's untrue—private venture capital tends to cluster around relatively few market sectors. They focus on opportunities that have the potential to generate at least a 30X return on investment (i.e., a $1 investment grows to $30 in value)—ignoring those that offer less or that are riskier.

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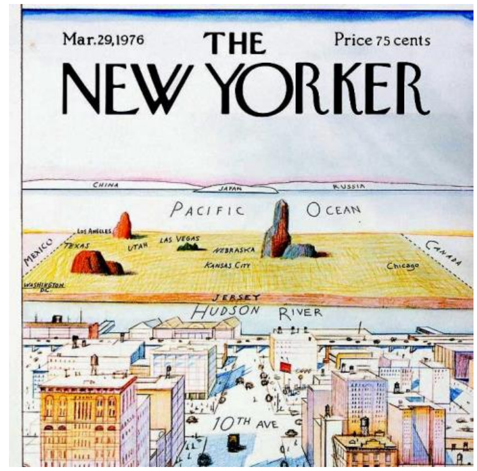
[38] A start-up CEO who was otherwise seemed to be an exemplar of virtue once urged me to "go to the dark side" when dealing with prospective investors because he felt pressure to bring capital in.

To pre-judge companies that seek capital from unaccredited investors as desperate demonstrates a world-view similar to the one satirized in an iconic *New Yorker* magazine cover, “A New Yorker’s view of the world”. Just replace Manhattan with a center of capital like Silicon Valley, NYC or DC. The buildings in the foreground represent opportunities that may generate $30 or more for every $1 invested in 3 to 5 years. Companies outside this neighborhood are on the other side of the Hudson River. Possibly, a nice place to go but “there’s just so little time and so much to do here in NYC (or in Silicon Valley)!”



In passing, I’ll note that private capital isn’t reasonably available to management teams of all backgrounds. Graduates of colleges that a preponderance of venture capitalists themselves attended are far more likely to get funded. Also, companies lead by women and minorities are significantly underrepresented in VC portfolios.

My point is that VCs don’t cover the universe of opportunity, and, a company that pursues a direct public offering is *not inherently inferior* to those backed by VCs. It’s true that promising companies prefer VC backing but more of them will consider equity crowdfunding if the benefits of doing so become apparent. Besides, since average investors can’t invest until a stock is public, it’s a bit of a moot point to compare a VC backed startup to a startup that uses equity crowdfunding.

So, with all that, four characteristics likely to be common to companies that adopt the Fairshare Model are:

1. The entrepreneurial team will be confident in their ability to perform.
2. The company cannot attract private capital *on terms that it is satisfied with*.
3. The issuer is willing to treat IPO investors as venture partners, not just as the ultimate Next Guy at the end of a series of VC rounds.
4. Management perceives that Performance Stock will give them a competitive advantage when recruiting and managing their workforce.

Notice that there is no minimum level of revenue or profitability or net asset value. The ONLY requirement to have a public offering is to have investors willing to buy the stock. If you doubt that, think about biotech companies that have a Wall Street IPO—few have revenue.[39]

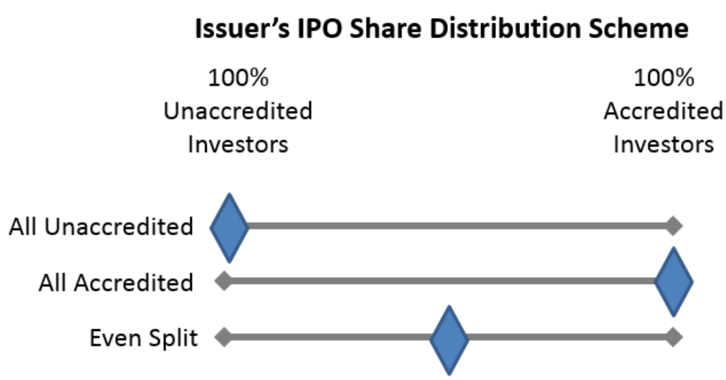
[39] Stock exchanges have minimum requirements, however. They include assets, number of shareholders and market capitalization. So, secondary trading markets have minimum requirements but are no comparable minimum qualifications to have a public offering.

Before we proceed to the categories, I want to make two points about how *any company* that uses the Fairshare Model will raise capital, whether it uses a broker-dealer or DPO.

First, all will target investors who have an affinity for what it seeks to accomplish, where the company is located or who is running the company. In other words, they will seek investors who are motivated by more than the potential to make money; those who want a reason to invest that isn't dependent on a financial payoff (i.e., a social benefit). So, all issuers will seek buy-and-hold investors--the type who knows the odds of failure are high and nonetheless supports the effort. The affinity may be based on the industry, technology, goal or the geographic location. It may be based on the management team. For some, it will be based on the Fairshare Model itself! That is, there will be investors who are inclined to invest in any company that adopts the model.

Second, the Fairshare Model is a loose construct for companies with respect to how they distribute their new shares. There will variation based on the needs of the issuer. At one extreme, the issuer will target only unaccredited investors. At the opposite extreme, the issuer will target accredited investors for the entire offering. An issuer might do this to avoid having the offering open too long. Wealthy investors would have the opportunity to sell off shares to unaccredited investors in the secondary market.

It may surprise you that this is a contemplated option because wealthy investors get all the IPO shares while the Fairshare Model aspires to provide opportunity for average investors. But if unaccredited investors are slow to buy, issuers will be wise to sell any available shares to accredited investors in order to minimize the duration of the offering. The Fairshare Model is a *practical form of idealism.* Those who matter most to me are the IPO investors because they supply the issuer with capital. The needs of the issuer come next in priority and those of secondary market investors come after that. In this effort to balance interests, there is a clear pecking order.



A Fairshare Model issuer might sell small stakes to a large number of unaccredited investors, large stakes to a few accredited investors or some combination of both.

A hybrid distribution plan with a mix of accredited and unaccredited investors is likely to be the most popular, especially as the total offering size grows.

Categories of Companies-Overview

So, what types of companies might adopt the Fairshare Model? Five categories are summarized in the following table and discussed in the pages ahead. Two of them are strategic for the Fairshare Model; I refer to them as Feeders and Aspirants. If they were race cars, a Feeder is a dragster that goes down a straight track as fast as it can—the race is seconds long. An Aspirant is a Formula One car that races for hours over a course with twists and curves. There are three non-strategic categories as well, Pop-ups, Spin-outs and "Rejuvenators."

Category of Company	Strategic for Fairshare Model?	Goal	Likely Offering Size	Likely to be a SEC Reporting Company?	Expectation of Performance Stock Conversion	Secondary Trading Market
Feeder:	Yes	Launch a product then get acquired.	\$3M to \$7M	Maybe	High	Pink Sheets; principal investor exit via acquisition
Aspirant	Yes	Build a company that lasts	\$5M to \$20M+	Yes	High	Pink Sheets, a regional exchange, or NASDAQ Micro for larger ones[40]
Pop-Up	No	Offer equity in a project	Less than \$5M	Unlikely	Low	Same as Feeder
Spin-Out	No	Alternative for a new VC round	\$5M to \$20M+	Yes	High	Same as Aspirant
Rejuvenator	No	Fund a turnaround	\$20M+	Yes	High	NASDAQ Micro or better

The table shows the goal of each and the likely size of their public offering. For example, Feeders are likely to have offerings between three and seven million dollars and Rejuvenators are likely to raise more than twenty million dollars.

Two adopters of the Fairshare Model may decide not to be a SEC "Reporting Company."[41] Such an issuer must file periodic shareholder reports with the agency (i.e. 10-Q or 10-K). In order to minimize overhead cost of this, Feeders and Pop-Ups might disclose in their offering document that they don't intend to be a reporting company. Other categories of issuer are likely to make it a priority to be one.

Except for Pop-Ups, all categories will have high expectation of Performance Stock conversions. The categories will vary in the secondary trading markets for their stock. The Pink Sheets (a/k/a Bulletin Board), where liquidity is slim to none will be the default for small offerings.

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[40] A comparison of listing requirements are here http://www.venturelawcorp.com/listing_requirement_chart.htm

[41] In December 2007, the SEC adopted scaled down reporting company rules for issuers that have a "public float valuation" of less than \$75 million http://www.sec.gov/rules/final/2007/33-8876.pdf

Feeders (a strategic category)

Feeder fish inspire this moniker. Aquariums use them as food for the larger fish in their collection; big fish eat little fish. The Feeder category is strategic for the Fairshare Model because these companies will most easily reap its advantages and successes here will lead others to adopt it.

A Feeder seeks capital to develop a product/technology that other companies will pay a premium for. Ultimately, its strategy is to be acquired at a healthy price. For entrepreneurs, this strategy avoids the cost, risk and stress of building the infrastructure needed for the long-term (i.e., employees, facilities, computer systems). Feeders focus on the technology, building a product and proving demand. For investors, a Feeder can generate a return faster than a build-for-the-long-haul company. Here are a few indicators that Feeders are common:

- In a thirteen month period, Yahoo acquired twenty start-ups.[42]
- From its 2006 inception through mid-2013, Twitter made 31 acquisitions.[43] In April 2014, it acquired a year old company that had raised $1.5 million.[44]
- In August 2014, Samsung acquired SmartThings for $200 million. In 2012, SmartThings used rewards-based crowdfunding to raise $1.2 million from 5,700 backers (average $210 per person) to launch its product. It went on raise $16 million from VCs before Samsung bought it.[45]

The Fairshare Model offers a Feeder an alternative to a VC round. Imagine a company raises $2 million from 100 angel investors who invest $20,000 each. It goes on to raise $10 million in a direct public offering where half comes from accredited investors and half from unaccredited investors in $200 allocations, as shown below.

	Investors		Total	Total
	Accredited	Unaccredited	Capital	Investors
Private offering	$ 2,000,000		$ 2,000,000	
Average investment	$ 20,000			
Number of investors	100			100
Direct Public Offering	$ 5,000,000	$ 5,000,000	$ 10,000,000	
Average investment	$ 20,000	$ 200		
Number of investors	250	25,000		25,250
Total after DPO			$ 12,000,000	25,350

As a result, there are about 25,000 investors, evangelists for the company's product, a few of whom may be able to generate interest by potential acquirers. A start-up can't have too many friends. By *spreading its shares* in this manner, this Feeder spawns interest in its success. By contrast, a competitor that relies on VC backing *must spend capital* to get such awareness. And, it can't spend enough on

[42] "The 20 Startups Marissa Mayer Has Acquired at Yahoo", by Lauren Indvik, Mashable, Jul. 31, 2013
[43] "The 31 Startups Twitter Has Acquired", by Taylor Casti, Mashable, Sep. 18,2013, http://mashable.com/2013/09/18/twitter-acquisitions/
[44] "Twitter Just Bought a Startup That Could Remake the Service", by Ryan Tate, Wired, Apr. 9, 2014, http://www.wired.com/2014/04/twitter-cover-buy/
[45] https://www.kickstarter.com/projects/smartthings/smartthings-make-your-world-smarter

advertising to sustain the interest that our Feeder created by making it possible for target customers to own a piece of the action.

Is a $200 investment sufficient to move 25,000 shareholders to actively promote the interests of the Feeder? Yes, for two reasons. First, people like to have a team to root for and they favor those with whom they share an affinity. Second, this investment is at a *wholesale valuation*, not the retail valuation that the public normally gets. The retail valuation could easily be 5 times higher than what the Feeder sold it for (i.e., they got a $1,000 stock for $200).[46] There is a glee factor in that.

In this illustration, the holders of Investor and Performance Stock have an aligned interest—they want to be acquired. Say that there is an offer for $40 million. So, $12 million in equity has been raised; $2 million in the private round and $10 million in the public one. Subtract that from the $40 million offer and there is $28 million of appreciation. How should that be split between the two shareholder classes? Two charts that follow will illustrate scenarios.

Before looking at them, recognize that both classes of stockholders must agree on how much Performance Stock converts and this agreement will vary by company.

One approach will be to decide by prior agreement. That is, a formula in the issuer's incorporation document.[47] A simpler alternative is simply to require approval of any acquisition agreement by both classes of stock. After all, this will be required even if there is a formula. No approval means no deal, so, shareholder groups that don't agree invite the problems of divided government.

The U.S. had this from 2010 to 2014. Republicans controlled the House of Representatives and Democrats had the Senate and the Presidency. In 2013, the two legislative bodies could not agree on a budget to fund the government. No budget meant government shutdown. To pass one, they fashioned a clause to implement automatic, painful budget cuts (a/k/a sequestration) if they later failed to agree on how to implement the budget. The clause forged approval for a high-level budget when there was no agreement on how to enact it.

If the Investor and Performance Stock don't agree on how to share a buyout offer, they face a comparable situation. They lose the deal and they must agree on how to raise any capital that is needed to continue operations as an independent company.

In this illustration, should there be an impasse, the acquirer might make separate offers for the Investor Stock and the Performance Stock, with employment agreements to enough employees to get Performance Stock approval. In other words, there may be a way to get the deal done when there is a lack of goodwill among shareholders. If not, the acquirer may come back with a lower price when the company is desperate for new capital.

In both scenarios that follow, there is prior agreement that Performance Stock equal to 2% of the Investor Stock outstanding as of the IPO converts each quarter (i.e., 8% per year). It is the deal that the company described in its offering documents; IPO investors got a low valuation in exchange for agreeing

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[46] The rise in the price of Investor Stock is a measure of performance for this Feeder—it generates conversions of Performance Stock to Investor Stock.

[47] The incorporation document is to a corporation what a constitution is to government. The initial agreement will be defined by the company and its initial investors. Amendments require from shareholders entitled to vote.

to this "presumed performance." This makes Performance Stock an effective incentive because employees can count on it. It also simplifies the issues of defining and measuring performance.[48]

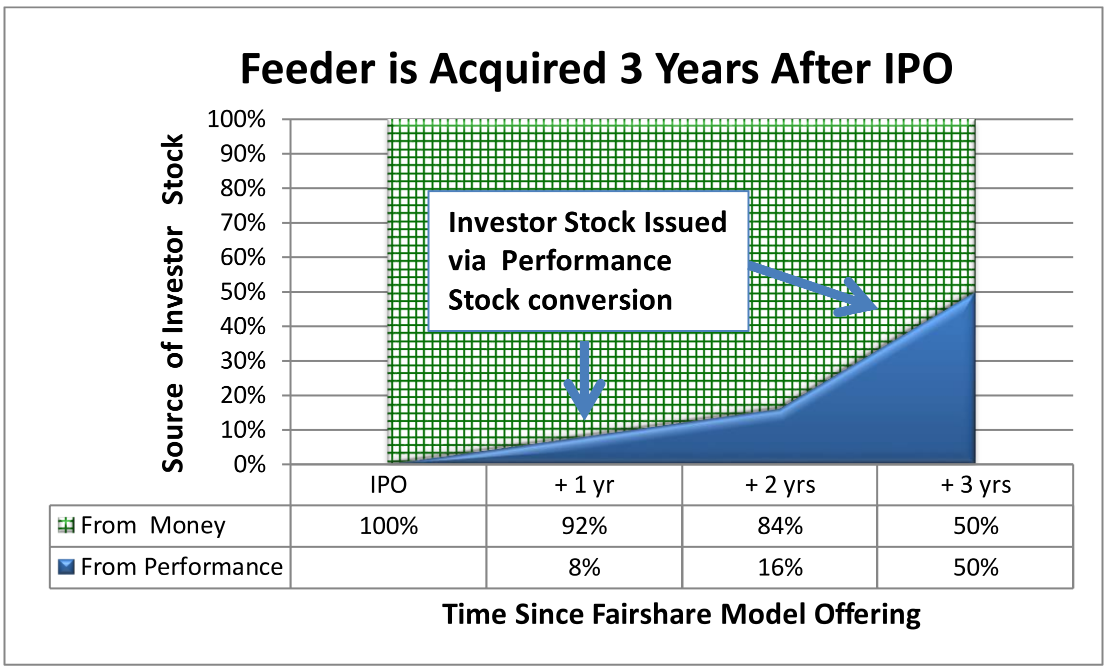
The chart below has the first scenario; the $40 million acquisition takes place *three years after the IPO* that raises $10 million. The green grid area shows the proportion of Investor Stock *outstanding at the close of the IPO*. The solid blue area is the proportion of Investor Stock that results from Performance Stock conversion. Note how the origin of Investor Stock shifts over the three years.

Of course, the number of shares of Investor Stock increases when there are conversions, but the chart does not measure that. Instead, it maps the two variables in this conceptual equation for the totality of the Investor Stock, assuming there has only been one offering.

100% of Investor Stock = % Issued at IPO + % Issued via Performance Stock conversion

or

100% of Investor Stock = Green Grid Area + Solid Blue Area



In the chart, a year after the IPO, the portion of Investor Stock from Performance Stock conversion is 8%.[49] Two years later, it's 16%. The acquisition offer comes three years later, so, more than 24% will convert (year two 16% plus 8%) because Performance Stockholders have delivered more than the nominal presumed performance. Here, the two classes of stock agree to a 50-50 split, so, enough Performance Stock converts to make the cumulative conversion 50%. At close of the deal, all unconverted Performance Stock is cancelled.

[48] A presumed performance can be constructed in many ways.

[49] It was 2% one quarter after the IPO, 4% after two quarters, 6% after three quarters and 8% after four quarters.

At the end, the shares the company sold for $12 million share half the $28 million in appreciation or $14 million. Those who had Performance Stock share the other $14 million. Not bad for three years work.[50] In all likelihood, the employees are richer than if the company had raised the $10 million from VCs instead of the IPO.

Why would this be so? Because professional investors need a bigger payoff than angel investors and average investors. VCs demand a higher return because their limited partners---those who invest in their funds---expect an attractive return and the general partners want a payoff too.

Aside from the financial payoff, the entrepreneurial team enjoyed more control over the company than it would have had VCs provided the $10 million. Their voting power is based on Investor Stock they earned for pre-IPO performance plus the Performance Stock that they control. For entrepreneurs, the ability to chart and hold a course can be at least as important as a financial payoff.[51]

The company's angel investors benefit in this example too. They invested $2 million and didn't have to invest more because public investors did.[52] The IPO money was on terms that were friendlier than a VC would offer (e.g., no dividend, management fee or liquidity preference). Plus, the angel investors had a liquidity option during the three years after the IPO; they could sell some or all of their shares, something they could not do if the company had been private.

[50] This is in addition to employee pay and any thing earned on options on the Investor Stock

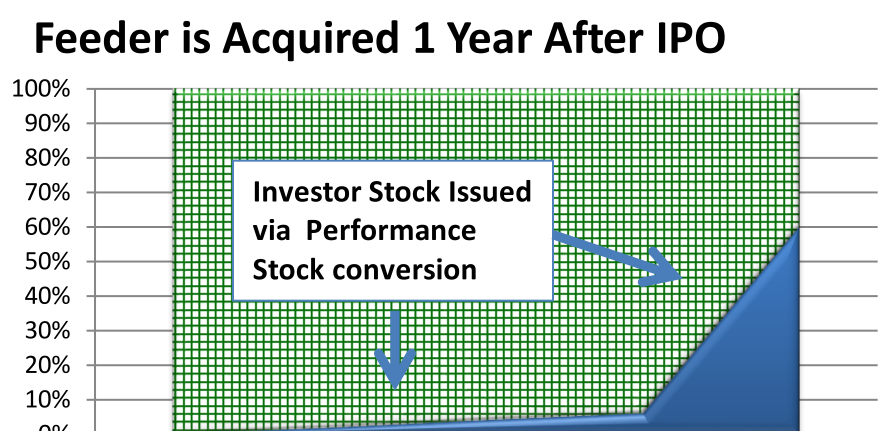
[51] The entrepreneurial vision is often centered in one person, the CEO. To keep this discussion from getting more complex, I don't attempt to separate his/her interests from other employees.

[52] In a VC deal, earlier investors can be compelled to invest in a future round or face loss of their position.

In the second scenario, the $40 million acquisition offer comes *1 year after the $10 million IPO*. The only difference is that the offer comes two years earlier. Arguably, Performance Stockholders deserve more of the $28 million appreciation because they delivered it much faster. Another argument for this is that public investors got a lower IPO valuation than they would have had the company used a conventional capital structure. Now that the true value is apparent, it is time to more fairly divide it.

In the chart below, the horizontal axis shows time in four quarters, not three years as in the last one. Like before, presumed performance results in quarterly conversions equal to 2% (8% per year) of what is outstanding after the close of the IPO. As a result, converted Performance Stock accounts for 2% of all Investor Stock one quarter after the IPO, 4% after two quarters and 6% after three. It would be 8% at the end of four quarters but the acquisition offer changes that. Now, the question is “how to divvy up the $28 million in appreciation?”

Here, the two classes of stock agree that the Performance Stock deserves 60% of the Investor Stock issued as of the IPO. So, 40% or $11.2 million of the $28 million goes to the Investor Stock and 60% or $16.8 million goes to the Performance Stock. Again, any unconverted Performance Stock is cancelled upon close of the acquisition transaction.



	IPO	+ 1 Qtr	+ 2 Qtrs	+ 3 Qtrs	+ 4 Qtrs
From Money	100%	98%	96%	94%	40%
From Performance		2%	4%	6%	60%

Time Since Fairshare Model Offering

Take-away: companies with a Feeder strategy will be attracted to the Fairshare Model because its employees can earn more of the appreciation than VCs would allow.

Sidebar on the Cost of Being a Public Company

Before moving to the next category, Aspirants, let's touch on the expense of being a public company. Broadly, this is the duty to file public disclosures with the SEC about financial statements, significant changes in ownership, management changes and anything else that investors are likely to consider relevant to their decision to buy, hold or sell the company's stock. An issuer that complies with these requirements is a "reporting company". Stock exchanges will not a list the stock of an issuer that is not a reporting company but they can be traded in the swamp alternately known as the pink sheets, bulletin board or over-the-counter market.

To begin with, there is the cost to prepare and sell the actual offering. The more history to disclose, the more expensive it is to prepare the offering document. Since a start-up has little history, it has little to disclose. As a result, it can get an offering prepared for $20,000 to $60,000. Then, there is the cost to sell the offering. If a broker-dealer is hired, the commission will run 8% to 12%, plus other expenses. A major objective of crowdfunding is lower costs to raise capital.

The annual cost to be a small reporting company can easily run $400,000 to $800,000 when one considers legal, audit, investor relations, employees knowledgeable about SEC requirements and insurance premiums for director and officer liability. The JOBS Act reduces some obligations for small public companies, but the cost of compliance remains significant, regardless of the capital structure. Much of the cost is fixed in nature so it falls more heavily on a company that raises, say, $5 million than on one that raises $20 million.

These costs will be a concern for Feeders. Some will meet the requirements to be a reporting company but some will choose to not be one so that they can maximize the funds available for product development and operations. Hopefully, an issuer that takes the later route will disclose this intent in the offering document by saying something like this:

> *Your investment is a chip in a game of chance. The odds of a payoff are not good and they are not improved if we spend a significant portion of the money we raise from you to be a reporting company. To maximize the resources that we can apply to our product development and launch, we may elect to not be a reporting company—making it more difficult for you to find a buyer for your shares. Should we not be a reporting company, we intend to notify shareholders of business developments and actions that require their approval. If we are not a reporting company, Performance Stock conversions will be suspended and our directors and management pledge to not sell their Investor Stock until we have been a reporting company for 90 days.*

Essentially, I offer for discussion two strategies for Fairshare Model issuers to deal with the costs of being a reporting company:

- Plan A: view the expense a cost of doing business; accept it and try to contain it.
- Plan B: don't be a reporting company but forewarn investors and don't allow insiders to acquire or sell Investor Stock while the condition persists.

Aspirants (a strategic category)

The Fairshare Model is designed for a company with what I call an Aspirant strategy. It aspires to build for the long-term. If it's to be a party to an acquisition, it intends to be the acquirer, not the acquired.

The metaphor for an Aspirant is a Formula One race car because it needs to maneuver through a more complex course over a longer period than a Feeder faces. That's a way to say that Aspirants will have a complex challenge of defining and measuring performance over a sustained period of time. Ideas for how to accomplish this will be a focus of the shake-down phase of the Fairshare Model—one that will involve lots of people.

A Feeder is strategic category for the Fairshare Model because its path to success is relatively simple; raise the money, build the product and decide how to divide the acquisition price. It's a limited test of the model. An Aspirant is a strategic category because it is full test of the model; how does an organization coordinate incentives for labor and capital in order to create competitive advantage? Given time and experience, a set of proven best practices will be identified for Aspirants. At that point, the Fairshare Model will be positioned to be adopted on Wall Street.

Compared to a Feeder, an Aspirant's two shareholder classes have a greater need to collaborate because adjustments to the conversion rules will be a way of life. How these groups view performance will evolve as the company and its environment does. Their ability to cooperate will be tested by external factors (i.e., economic conditions, market shifts, competition, availability and price of materials, etc.) and internal factors (i.e., leadership, employee turnover, disrupted plans, etc.). Changes in the composition of each shareholder class will also play a role; investors who buy their stock at the IPO will have a different perspective on performance than those who invest later. For all of these reasons, an Aspirant will face greater challenges than a Feeder.

On top of that, there will be variation based on industry, stage of development, geography, and personality. That's why there is much to learn from the shake-down phase of the Fairshare Model and the experience of early adopters. Nonetheless, some ideas can be sketched out now.

When defining performance for a start-up, revenue and profitably will be standard but possibly inadequate measures. Some may not have a product for a while. Important measures of performance like strategic partnerships, design-in agreements, securing distribution and even customer orders may take a while to be expressed as revenue or profit. Cash burn rate is a vital operational measure but potentially difficult for setting conversions. The same could be said for non-financial criteria such as product release, quality, market penetration and growth in customer base. Non-traditional measures of value-creation such as environmental impact, job creation and awards are similarly challenged.

You might think that "performance" would be relatively easy to define and measure, but it is not. Think about things that are widely shared aspirations—peace, justice, fairness, quality, or effectiveness. How easy is to come up with a shared definition? Think about things that are generally viewed in a negative light—it may be slightly easier to find a consensus definition for harm, injustice, unfairness and so on. Often though, we are like U.S. Supreme Court Justice Potter Stewart when he issued an opinion in 1964 on whether material was pornographic. He said that he would not attempt to define what the word meant "but I know it when I see it." When it comes to defining performance, many feel similarly, which presents a significant challenge for the Fairshare Model—can holders of Investor and Performance Stock agree what they see and what it is worth?

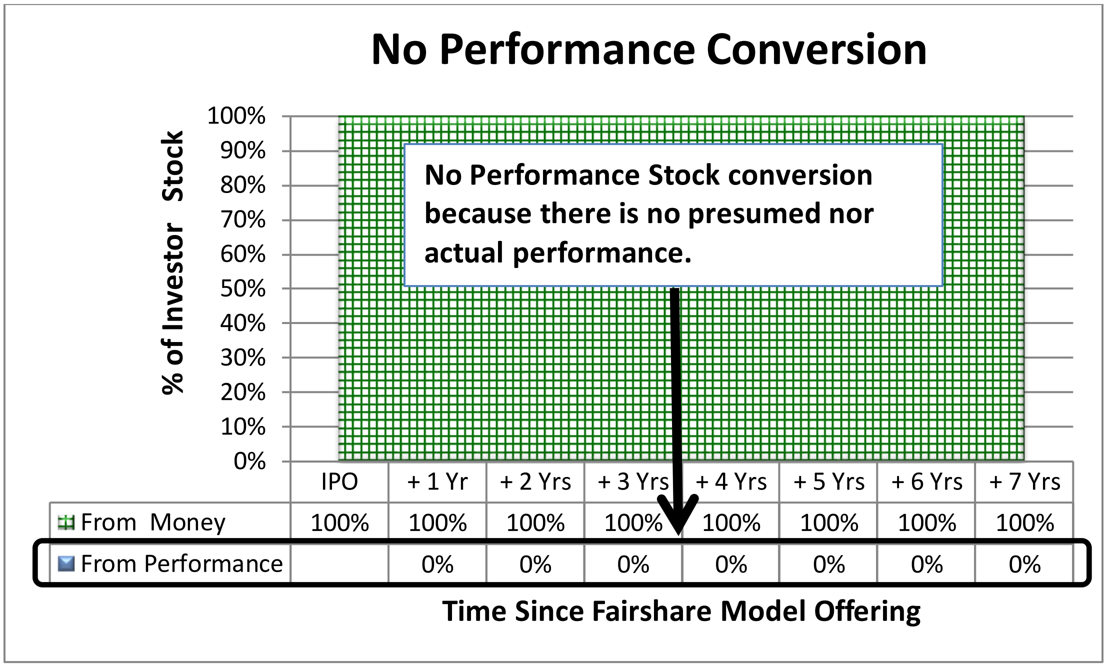
That said, I think any definition of performance should include the raise of additional capital on favorable terms. Funding operations is the most important task for a venture-stage company for it is kaput if it fails to do so. Arguably, another measure of performance should be the market value of the Investor Stock. If it climbs, one can infer performance. But this logic has limits—should one infer a lack of performance if the stock price drops?

The difficulty of defining performance makes a case for presumed performance as a function of time. This is what most employee stock option plans do—the kind that are standard fare for technology companies and others. Employees get an opportunity to buy stock in the future at the current price. This right or option typically vests, or becomes exercisable, over time. A company using the Fairshare Model might use this approach---have conversions based on presumed performance—while also allowing for additional, performance-based conversions.

Such a hybrid conversion criteria keeps the Fairshare Model attractive for IPO investors, the company and its employees. Investors get a deal on the Investor Stock—a deep discount from what the valuation would be if the issuer uses a conventional capital structure. They know that a baseline amount of Performance Stock will convert each quarter. They weigh its dilutive effect on percentage ownership against the prospect that the Investor Stock will rise in price, then sell or hold their shares. New investors will have access to the same information and make a similar assessment. The appeal for the issuer and its employees is that Performance Stock is likely to be an effective tool to recruit and motivate desirable employees.

There is plenty to think about on this topic. The following charts illustrate three basic scenarios over a seven year period. The first assumes no Performance Stock conversion. The second assumes presumed performance up to a capped level. The third has presumed performance for two years and strong actual performance thereafter. Collectively, they provide a range of outcomes that could apply to an Aspirant, depending on how performance is defined and delivered.

The following chart illustrates no presumed or actual performance—the most adverse scenario for employees. Metaphorically, this Formula One race car had fuel (cash from the IPO) but it didn't complete a lap of the track. Bad car, bad driver or bad weather—whatever the reason(s) it turned out to be a dud. So, only those who pay money for shares or earn them with pre-IPO contributions have Investor Stock.



	IPO	+ 1 Yr	+ 2 Yrs	+ 3 Yrs	+ 4 Yrs	+ 5 Yrs	+ 6 Yrs	+ 7 Yrs
From Money	100%	100%	100%	100%	100%	100%	100%	100%
From Performance		0%	0%	0%	0%	0%	0%	0%

This presents an interesting hypothetical. What might happen to such a company when it is about to run out of money? The basic outcomes are:

1. New capital is raised.
2. The company is acquired.[53]
3. The company dissolves.

Each outcome has potential legal issues involving the respective rights of the Investor Stock and Performance Stock. But remember, this book's purpose is simply to create interest in the Fairshare Model, not provide a how-to guide. If there is enough to get the entrepreneurial community excited, the shake-down of the model will address ideas for how Performance Stock might work in these scenarios and they will be tested by early adopters.

Bear in mind that a conventional capital structure has to deal with the three outcomes too.

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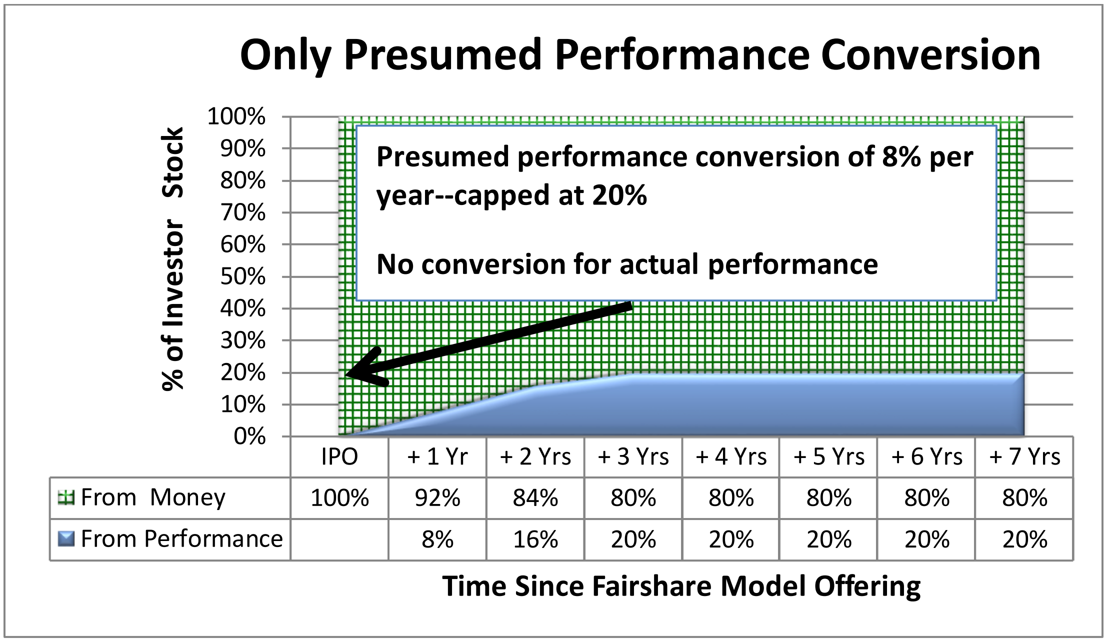
[53] It is non-obvious, but a failed public company has intrinsic value. A private company can become publically traded via a "reverse merger" with a failed public company. You can learn more about this type of transaction online.

The following chart illustrates a scenario with presumed performance conversions for the four years following the IPO. After that, conversions require actual performance…but there is none.

Note that the time scale on the horizontal axis covers eight years, the IPO and the seven successive years. The presumed performance is what it was in the two previous scenarios, 8% per year of the Investor Stock outstanding after the IPO (or 2% per quarter), up to 20%. Here, the conversions stop after the cumulative percentage is 20%, four years after the IPO. It doesn't go higher because actual performance the fourth year is insufficient to trigger additional conversions.

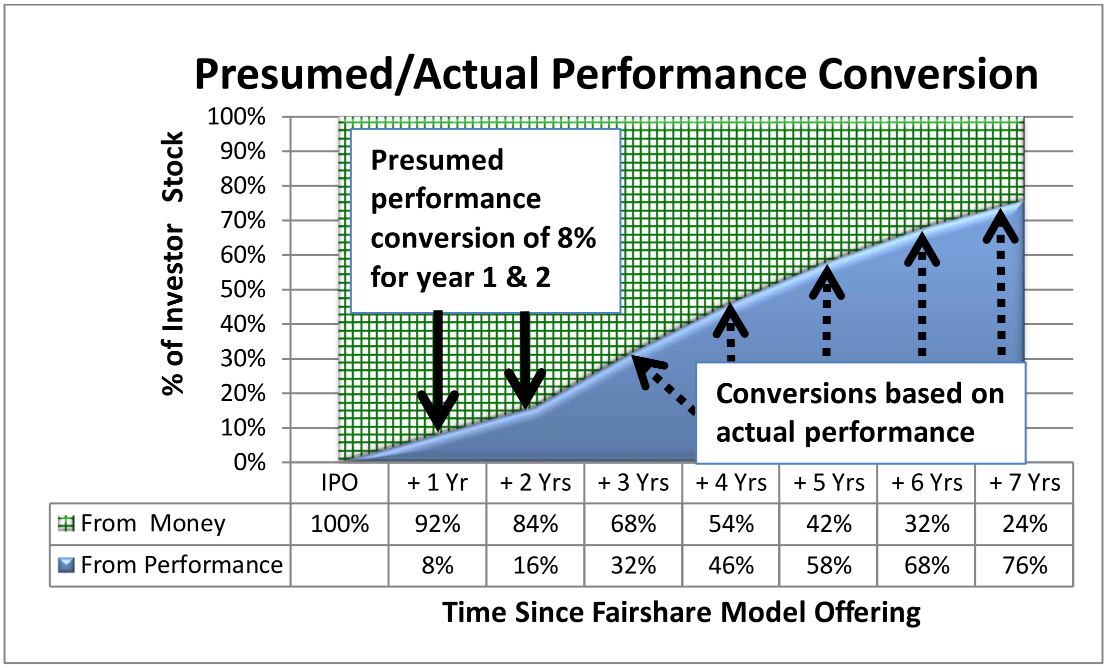


Again, this is a conceptual example. Should the annual conversion rate and/or the maximum for presumed performance be different than modeled here? These are questions to be discussed!

Just like the prior charts, this one shows the origin of the composition of Investor Stock. It says nothing about who owns the shares. That's because anyone with Investor Stock can trade it.

Also, the chart does not illustrate the effect of issuing additional Investor Stock for more capital (or to acquire another company).

The third and final Aspirant chart is below—it's a blend of assumed performance and strong actual performance. There are two years of presumed performance conversions using the same 8% per year (2% per quarter) assumption as in the last scenario. But look at what happens three years after the IPO. The cumulative conversion is 32%! If the annual 8% factor was applied, the cumulative conversion would be 24% (3 years times 8%). But, the cumulative conversion is 32%, which means the year three conversion was 16% (32% minus 24%). Double the rate in the first two years!



	IPO	+ 1 Yr	+ 2 Yrs	+ 3 Yrs	+ 4 Yrs	+ 5 Yrs	+ 6 Yrs	+ 7 Yrs
From Money	100%	92%	84%	68%	54%	42%	32%	24%
From Performance		8%	16%	32%	46%	58%	68%	76%

The reason for the increase in year three is that actual performance exceeds the minimal presumed performance. And not just in year three! In the fourth year, the cumulative conversion from performance is 46%, so, the conversion was 14% that year (i.e., 46% minus year three's 32%). In year five its 12% (i.e., 58% minus year four's 46%). In year six its 10% (i.e., 68% minus year five's 58%). In year seven its 8% (i.e., 76% minus year six's 68%). This scenario could describe a company that spends the two post IPO years to develop its product then has a spurt of accomplishment that later tails off.

Starting in year three, take note of the cumulative percentage of Investor Stock that results Performance Stock conversions. The year three 32% is on the high end for what happens in a VC financed deal. But, it climbs to an unheard of 76% at the end of year seven! Recognize that some employees—founders and initial employees—have Investor Stock at the IPO (i.e., what's in the green grid area) for pre-IPO performance. The conclusion? **An entrepreneurial team that adopts the Fairshare Model can wind up with more ownership than they will when VCs finance their company, provided they perform as their Investor Stockholders expect.**

Like the two preceding charts, this one assumes that the company does not issue new Investor Stock. If it does, new investors are sure to buy in at a higher valuation. As a result, all owners of Investor Stock are happy, regardless of whether they bought their shares or earned them via performance.

The range of possible scenarios is beyond the scope of this book. It will take time to identify the Dos, Don'ts and Gotchas that may be important for an Aspirant. One thing is certain, however, the CEOs of Aspirants will have superior ability to communicate, inspire and manage. They will have keen insight into human behavior and group dynamics. They will also be able to strike a balance between their ego and willingness to be accountable to both classes of shareholders.

What works at one company may not work at others. Indeed, there will be variation based on industry, stage of development and geography (i.e., what works in Texas may not work in California). There will also be legal, tax and accounting issues that all issuers must address. The good news is that there will be legal, tax, financial and organizational specialists who are eager to help. And, importantly, the benefits promise to exceed the costs of making the model work.

Pop-Ups (a non-strategic category)

The name "Pop-Up" is inspired by pop-up stores, those that lease space for a few months. The landlord rents space on a short term basis while it waits to secure a long-term tenant or to do something else with the vacant space. The store wants a place to conduct business without a long-term lease. In the U.S., retailers who specialize in Halloween goods pop-up in September then go away in November. Such activity has gone on for decades but the term "pop-up" is of recent vintage. It reflects rising interest in entrepreneurship; an opportunity for entrepreneurs to see if might be on to something.

In the context of the Fairshare Model, a Pop-Up is a company that sells stock to the public to fund a project. The project might be a product, a movie, a game or an oil well. It might be a cause, like an effort to fund research, improve a city, agricultural practices…use your imagination. At present, this type of money is raised via donation or advance payment for the product that will be produced with the money. Crowdfunding sites are often used. The difference here is that people who "invest" in a Pop-Up get more than a good feeling for their money—they get stock.

From an investor perspective, a Pop-Up has dubious commercial viability in the sense that it will need money later and questionable whether others will provide it. From an entrepreneurial perspective, a Pop-Up is a bud of hope, an indication that investors share the sense of what might be possible…an Aspirant, or at least a Feeder.

So, investor and entrepreneur share a space—a view of the worthiness of the project—but not necessarily a perspective on the prospect for financial reward. That is, the backers may be willing to support the project without equity. If they get stock, they might donate more…its hard to say; they may just feel better about the donation.

Pop-Ups are not a strategic category for the Fairshare Model because they are unlikely to be acquired or become a reporting company. As a result, their performance is unlikely to generate a *financial return* for shareholders, whose money is better characterized as a contribution than an investment.

Start-up game developer raised $51 million via contribution and reward based crowdfunding

When *Star Citizen* first appeared on Kickstarter, it had a goal of $0.5 million; it raised $2.1 million by November 2012. "Sales and members of our community are the two main fund raising sources," game creator Chris Roberts said on his website. By December 2014, it had raised $65 million via reward-based crowdfunding.

Roberts said "Star Citizen isn't a normal game. It's not being developed like a normal game and it's not being funded like a normal game. I've had to toss aside a lot of my knowledge from the old way of developing and embrace a completely new world. There is no publisher. There is no venture capitalist wanting a massive return in three years."

Spin-Outs (non-strategic category)

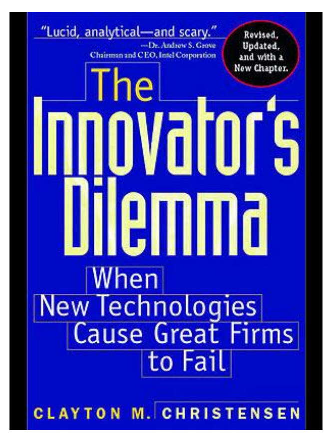
A Spin-Out is company that has raised capital from a venture capital fund but is not a good candidate for another. VCs refer to these types of investments as the living dead or zombies. To apply a baseball analogy, they are a first or second base hit in a game where a home run or triple is the goal.

The Fairshare Model should interest VCs because it offers the opportunity to spin-out such companies in their portfolio (i.e. public investors fund the next round), which allows them to distribute shares in these companies to their limited partners (i.e., institutional and wealthy individual investors). These investors would get Investor Stock and, possibly, Performance Stock as well. The combination would provide limited partners with liquidity plus an upside if the company performs well.

Spin-Outs are a non-strategic category for the Fairshare Model because it will not develop unless and until the model works for Feeders and Aspirants. Time and experience are not the only barriers to adoption; Spin-Outs mess with two elements of the VC model.

The first is the idea that *public investors should pay a high valuation for a promising story.* VCs are accustomed to seeing high valuations for *potential successes*—this precept is expressed in private rounds, acquisitions and IPOs. VCs clearly agree with the valuation ideas behind the Fairshare Model—they insist on them in their own deals—but some of them have a problem with the idea that public investors should be able to adopt them too. Some will see risk to offering shares in a VC-backed enterprise at low valuation. Others will think that it is crazy to offer the public a low valuation on one that has good potential. A similar sensibility once led retailers of brand-name goods to eschew discount stores. But premium outlet stores demonstrate that there is a way to maintain retail pricing in traditional stores and discount pricing elsewhere. So, I don't doubt some VCs will see potential in the Spin-Out strategy.

The second element in the VC model threatened by a Spin-Out strategy is the relationship that a fund's general partners have with their limited partners---those who provide the capital to invest.[54] If VCs utilize a Spin-Out strategy, it might invite scrutiny of general partner compensation.



Nonetheless, some VCs will explore Spin-Outs—*if* Feeders and Aspirants have good results. The reason is suggested in a 1997 book by Clayton Christensen that has been read by virtually every VC, *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*. Christensen describes how new entrants in an industry attack the dominant players from the low-end of the market, offering products that are cheaper and/or better in quality, design, etc. For instance, somnolence on the part of U.S. and European auto makers created an opening for Japanese manufacturers in the '60s and '70s—they ignored the low end of their markets. Korean automakers later adopted a similar strategy to take market share from American, European and Japanese companies.

[54] A VC fund's general partners manage the fund and its investments—they provide labor, not (significant) capital. A funds limited partners provide capital, no labor.

Christensen's book provides examples in computers, steel and even milkshakes. Below is an excerpt from a 2013 interview he had with Jeff Howe of *Wired* that discussed a 1996 meeting he had Andy Grove, then CEO of Intel Corporation about disruptive innovations.[55] [*Italics added for emphasis*]

> **Clayton Christensen:** You could see how, in each generation [of computer disk drives], an established company would start focusing on bigger, more powerful disks for the top end of the market and then just get wiped out when the lower end of the market found a way to make smaller, cheaper disks, even though those had lower profit margins. It made *my thesis. Smart companies fail because they do everything right. They cater to high-profit-margin customers and ignore the low end of the market, where disruptive innovations emerge from.*
>
> **Jeff Howe (Wired):** Is this around the time that Intel CEO Andy Grove heard about your work?
>
> **Christensen:** This was before the book came out. I'd published two papers on my theory, and a woman who worked in the bowels of Intel's engineering department went to Andy and said, "You have to read this article. It says Intel is going to get killed." I hadn't even mentioned Intel, but the implications were there. So Grove called me up, and he's a very gruff man: "I don't have time to read academic drivel from people like you, but I have a meeting in two weeks. I'd like you to come out and tell me why Intel's going to get killed." It was a chance of a lifetime. I showed up there. He said, "Look, I'll give you 10 minutes. Explain what you think of Intel." I said, "I don't know anything about Intel. I don't have an opinion. But I have a theory, and I think my theory has an opinion on Intel." I described *the idea of disruptive innovations*, and he said, "Before we discuss Intel, I need to know how this worked its way through another industry, to visualize it." So I described how mini mills killed off the big steel companies. They started by making rebar cheaper than the big mills did, and the big mills were happy to be rid of such a low-margin, low-quality product. The mini mills then slowly worked their way upward until there was nothing left to disrupt.
>
> **Howe:** What did Grove say?
>
> **Christensen:** He cut me off before I could finish. "All right. I got it," he said, and then he described the whole thing. Instead of the mini mills, there were two microprocessor companies, Cyrix and AMD, making cheap, low-performance chips. Grove says, "*What you're telling me, Clay, is that we have to* go down and kill them, set up our own business unit, and *launch our own low-end competitor."* I didn't say anything. I wasn't going to be suckered into telling Andy Grove what he should do with Intel. I knew nothing about semiconductors. Instead of telling him what to think, I told him how to think.
>
> **Howe:** What did Intel wind up doing?
>
> **Christensen:** They made the Celeron Processor. They blew Cyrix and AMD out of the water, and the Celeron became the highest-volume product in the company. The book came out in 1997, and the next year Grove gave the keynote at the annual conference for the Academy of Management. He holds up my book and basically says, "I don't mean to be rude, but there's nothing any of you have published that's of use to me except this."

The Fairshare Model is a *disruptive innovation* in financial services. It will unsettle VCs and the Wall Street banks that make boatloads of money selling shares in venture stage companies to public investors (a/k/a "the high-profit-margin customers"). But VCs are cut from the same cloth as Andy Grove. They are alert to threats and they adapt.

[55] "Clayton Christensen Wants to Transform Capitalism" by Jeff Howe, Wired, Feb. 12, 2013 http://www.wired.com/2013/02/mf-clayton-christensen-wants-to-transform-capitalism/all/

Rejuvinators (non-strategic category)

A “Rejuvinator” is a medium to large company that is in financial distress. They can raise capital using a conventional capital structure, but such a deal doesn’t have Performance Stock.

Rejuvinators are a non-strategic category for the Fairshare Model because Aspirants must first demonstrate that Performance Stock can help a company attract and manage human capital. It is also a whimsical category because I see the potential to do something good—rejuvenate the relationship of labor and capital in companies that need to reinvent themselves. This category conjures up established companies that failed to adapt because their leadership was not imaginative or bold enough. Think General Motors, Sears and Roebuck, U.S. Steel, Eastman Kodak and many others.

Here’s a thought experiment. Think about the myriad challenges that GM faced, starting in the 1970s, when the era of rising fuel prices began—low mileage products, uncompetitive manufacturing costs and quality. Now, imagine its response if it’s capital structure had been based on the Fairshare Model. Surely, if employees had Performance Stock, their response to these developments would have been very different because:

1. They would be able to vote on shareholder matters (i.e., the board of directors, which hires and fires officers; executive compensation), and
2. They would benefit financially if the company met performance targets agreed to by its Investor Stockholders.

Had the interests of capital and labor been better balanced and aligned, the quality of communications, the sense of urgency, responsibility and commitment among all levels of the organization would surely have been better. It seems likely that the United Auto Workers would have approached contract matters differently were its members more concerned about GM’s vitality (i.e. they would not have used zero-sum game theory). The union might have been less concerned about wages and benefits and more interested in enhancing worker training and involvement in process improvement. It seems likely that all employees would have focused more on the long-term health of the company, valued knowledge-based authority (including collaboration) over hierarchical-based authority, and would have been more inclined to take product risks. Simply put, had GM used the Fairshare Model, it is difficult for me to imagine that its decades-long decline would have persisted, let alone led to bankruptcy. I think the Fairshare Model would have helped GM be a more dynamic, vibrant organization. One that would have generated benefits for investors, employees and the communities it operated in.

The standard tonic for an underperforming company is to hire a turnaround CEO who will fix or cull money-losing products and cut expenses (jobs), among other things. There are good reasons for these actions, but they often happen so late that desperate, painful actions seem to be the only option. I purport that the Fairshare Model has the potential to help low-performing companies arrest their decline earlier and, thus, minimize the havoc often associated with a turnaround.

Balance and alignment between capital and labor does not avoid the need for painful adjustments but should help organizations spot underlying problems early and address them in an effective manner.

Possible Variants

Once the conversation about the Fairshare Model gets rolling, the categories of companies are sure to be expanded and refined. I offer two more to provoke your imagination. The first is a bank. The second is essentially a public venture fund that raises capital using a Fairshare Model IPO.

The first idea is inspired by Kim Kaselionis, who had been CEO and chairman of a bank before she founded Breakaway Funding, a crowdfunding platform.[56] She see potential for equity crowdfunding to help small banks attract capital, enabling them to make loans to businesses in their community. Recast the idea so that its by industry—organic farming, solar industry, etc.—and you see additional potential. A bank that utilizes the Fairshare Model could have appeal to a large number of investors who are prepared to define performance in non-traditional ways.

As for the second idea, securities law allows a company to raise capital to invest in other companies. If the company raising the money has a target company in mind for an investment, significant disclosures must be made about the candidate. However, if the company raising the capital has no target companies, there is nothing to disclose other than what is ordinarily required for an issuer. Such a company raises capital for what is known as a "blind pool" or "blank check" offering or a Special Purpose Acquisition Company (a/k/a SPAC).

Such an offering holds beguiling prospect to create venture funds that have an investment criteria that would appeal to a broad range of interests. Here are some possibilities:

- Geo-centric: funded companies will be based in a geographic region or state;
- University-centric: funded companies have a tie to the school (e.g., license intellectual property from it, founders are alumni or come out an affiliated incubator). One idea would be to crowdfund a company that funds work in a research lab; in exchange for the funding, the company would share intellectual property rights with the university; and those who are funded.
- Industry-centric: funded companies will be focus on business sectors that may have difficulty attracting capital from traditional venture funds (e.g., agricultural, natural resource conservation, alternative energy, services for the aged, grocery stores that provide low-cost healthy foods in poor neighborhoods).
- Demographic-affinity: funded companies will appeal to investors because of demographic qualities about the entrepreneurs or their target customers. Segments might be defined by gender, age, ethnicity, etc.

Such initiatives will involve intriguing ideas about how to distribute Performance Stock and what the conversion criteria will be. Indeed, it's possible that some efforts will have such a charitable focus that there is no conversion of Performance Stock at all---it can only vote. These social investing ideas could work with a conventional capital structure, but it seems more likely to actually come to being with the Fairshare Model.

[56] For more information about Breakaway Funding visit www.breakawayfunding.com

Can One Tell What Category a Company Is?

One can't always tell what kind of strategy a company's executives really have. They can be like a mythical shapeshifter. A Feeder may tell you it's a Feeder....but it might may tell you that it's really an Aspirant. A Pop-Up may think that it's a Feeder or Aspirant. A Spin-Out can't remain a Spin-Out—it must evolve into a Feeder or an Aspirant. And, an Aspirant may wind up being a Feeder after all.

Think of these categories as specific martial arts moves (i.e., a particular kick, block or blow) that are learned separately, then combined in a seamless manner. They highlight scenarios that need attention from attorneys and people with insight into organizational behavior and game theory. Ultimately, though, the ability of shareholder classes to cooperate is the key to making the model work.

Regardless of the "category", early adopters of the Fairshare Model will be intrepid entrepreneurs who are prepared to tackle their Ponderables.[57] They will be practical idealists; focused not only on how to make the model work for them, but also intrigued by the opportunity to reinvent capitalism. What they experience will be of intense interest to many because the Fairshare Model upends traditional precepts about capital formation and the relationship between labor and capital.

- Bad experiences attributed to the model will discourage others from adopting it. As these occur, I hope for fair and balanced analysis as to the nature of the cause. As a practical optimist, I'm confident that any problems with the model can be overcome.
- Fair-to-good experiences will encourage experimentation with new approaches.
- Good-to-great experiences will usher in a new era of venture capital, and, it will prod mature companies to better align the interests of their shareholders and employees.

Onward

We've established that companies that adopt the Fairshare Model will be confident that they can perform and engaged in useful speculation about the types of companies that are likely to adopt it. Importantly, it's been underscored that most of these companies will offer poorer liquidity options than venture stage companies that are brought to market by Wall Street investment banks. The saving grace is that issuers that use the Fairshare Model will offer investors a much lower valuation.

Next, I'll describe the history of the Fairshare Model and speculate on how it will and when it will become the New Normal for how start-up companies raise public venture capital.

[57] The Ponderables are at the end of chapter three.

Chapter 7: Fairshare Model History & Projection

Preview

- Foreword
- My Path to the Fairshare Model
- How the Fairshare Model will emerge
- The Concept Gap
- Onward

Foreword

This chapter describes how I came to the Fairshare Model and how I expect it will emerge to become the New Normal for companies that seek to raise venture capital in a public offering.

My Path to the Fairshare Model

My path to the Fairshare Model became clear in the early 1990s, when I began offering consulting chief financial officer or controller services to start-ups in the San Francisco Bay area.

Preceding that, I worked for two Fortune 500 manufacturers in the Midwest, then at some smaller ones in Silicon Valley. Two of these California companies were remarkable for very different reasons. One had a strong performance-driven culture that had been established by a turnaround manager who had a long run of success. The other was a start-up that failed in spite having every possible predictor of success that one could imagine.

As a consultant, I saw companies that seemed deserving of investment that could not get the attention of venture capitalists. As I learned about the capital formation process, I discovered it to be rife with inefficiencies and bias.

One client was an environmental technology start-up. It had licensed technology from the Lawrence Livermore National Laboratories to use an electron beam to transform certain toxics into harmless components. Environmental technologies were uninteresting to VCs then, so, the company turned to angel investors. This method of fund raising worked but took a long time and led to inefficient development efforts. We wound up turning to a consultant with connections to a broker-dealer to raise private capital via convertible debt, not equity; this turned out to be expensive money in several respects.

As I discussed the challenges with John G. Wilson, another consultant from San Antonio, Texas, he described a long-standing vision that he had for an alternative approach to raising equity capital. It involved small public offerings, small investors and a performance based capital structure. The capital structure was the Fairshare Model.

It was fanciful in many respects, but beguiling. We worked on it for a few months; identifying issues with what we now call equity crowdfunding and ways to resolve them. Mostly, we worked figuring out how to explain the concept and define a business model. We shelved the effort when we realized that the cost to print and mail offering documents was too high to make it work for issuers, given the low likelihood that a given mailing would result in an investment. Not only that, some states required that an offering document be cleared by its regulators before it could be mailed to a potential investor in that state. Their regulatory model was to regulate the offer of securities. The cost for this review was another barrier to feasibility; one had to pay the fee before one knew if anyone in that state would invest…or what amount.

October 1995, the heavens parted. The SEC announced that it was adapting its regulations to the then-emerging Internet Age. Electronic delivery of documents would be equivalent to the mail (i.e., one could email documents). Also, it would regulate the sale of securities, not the offer. The fact that the federal securities regulator took this position meant it would change the laws of the states.

The economics became feasible…potentially. There was so much still to evaluate.

We formed a company named Fairshare, Inc. and worked to implement John's core idea. Before 2001, when Fairshare sank in the wake of the dotcom and telecom busts, we had some success.

We were a frontrunner for the concept of equity crowdfunding (a/k/a "too early"). We showed that there was significant investor interest in the potential to invest in small companies using the Fairshare Model. We had 16,000 "opt-in" members, some of whom were enthusiastic enough to buy a paid membership ($50 or $100), but most signed up for our free membership. Unique visitors to our website was a multiple of our membership – it offered education on IPO deal structures and valuation. We had calculators to calculate valuation in multiple ways. That was the satisfying part—we discovered there was a market for the Fairshare Model.

The unsatisfying part was that we underestimated the difficulty we would face with securities regulators. It took far more time and money to find a place where securities regulators appeared satisfied with what we planned to do.

The core problem was that we positioned Fairshare to operate as a non-regulated entity.

We planned to build an Internet based community that, once it reached critical mass, could attract companies who wanted to pitch a direct public offering. Members would be able to pool due diligence. We said we would allow an issuer to pitch their DPO to our members for free (no commission) so long as it adopted the Fairshare Model and agreed to let members invest as little as $100. Fairshare would not handle investor cash or the issuer's stock but would influence the allocation of shares to members. Our plan was to make money from membership fees and, possibly, advertising; we had no intention of making money on investment transactions.

We saw ourselves as creating a web community. It would be a bit like Facebook, which launched about seven years later, in 2004. In ours, investors would be able to connect, learn about investing in start-ups and pool due diligence. It would also be an investor oriented version of Consumer's Reports, where our obligation was to our members.

Within months of launching the membership program, the securities regulatory agency for California had issued a "cease and desist order", stopping us from offering memberships to California residents. It said a membership—even a free one—was an investment contract….a security. As such, Fairshare would have to file a registration statement and presumably hire a broker-dealer to offer them. An administrative law judge denied our appeal. On its website, the California Department of Corporations identifies its decision is a "precedent case", one of six. You can see the list of cases here http://www.dbo.ca.gov/ENF/decisions/default.asp and read the ruling of the administrative law court here http://www.dbo.ca.gov/ENF/decisions/288.pdf, which is identified by the agency as the following.

Respondents: FairShare, Inc., aka FairShare Capital Markets; Karl M. Sjogren and John G. Wilson

- *Dept. file number: ALPHA*
- *OAH file number: N-1998110288*
- *Law(s) involved: Corporations Code §§ 25019, 25110, 25532*
- *Date of Decision: January 26, 1999*
- *Summary: Desist & Refrain order issued under Corporations Code § 25532 upheld based on finding that "membership interests" in "internet-based" organization were "investment contract" securities under both "traditional" and "risk capital" analyses.*

A few quarters later, we had queries from regulators in Ohio, Colorado and Texas. A membership was not a security under their law.[58] However, these states wanted to see a regulated entity involved when an offering was discussed and allocations of shares were managed.

To quell this concern, we formed a subsidiary that registered as a regulated Investment Advisor with the SEC and all states, including California. Eventually, we planned to ask the Department of Corporations if this would lead it to remove its cease and desist order on the offer of Fairshare memberships in California, but we had more pressing concerns. We needed more capital, to revise our approach to the business and more people.

I was tired. I had kept consulting CFO/Controller work as my "day job" during this 3 year effort. Doing that preserved our capital for expenses and for others who needed to be paid in order to work on Fairshare activity. John and I were also becoming frustrated with each other's view on how Fairshare should develop; a philosophic difference emerged.

John saw Fairshare as a closed system where the only offerings presented to members were DPOs that used the model and passed our screening. He did not want to see broker-dealers presenting offerings because he felt they would always be based on a conventional capital structure and, therefore, present an inferior deal to members. He also wanted to see the administration of Performance Stock for all issuers controlled by a single trust (i.e., a legal organization administered by a board of trustees). His view was akin to a *strong central government* or, to use a technology reference, a "walled-garden." A walled garden describes the experience used by America Online (AOL) back then and, nowadays, by Apple for its iPhones. John channeled the sentiment expressed in Apple's iconic "1984" super bowl ad, but to him, the enemy of the people was Wall Street, not IBM.

My view was evolving into a *strong local government* model, or, to use a technology reference, the approach favored by Microsoft's Windows operating system or Google's Android platform. I felt that

[58] SEC staff who I presented the matter to felt similarly—a membership was not a security under federal law.

members would prefer offerings based on the Fairshare Model, but that they would be most interested in the dynamics of a community. That is, the ability to share insight, be a target audience for *any offering* that met the standards of the community. So, I was open to the idea of offerings that used a conventional capital structure and/or were sold by a broker-dealer being brought to our members. I felt that if we could "organize the buyers" and help them learn how to be savvier, market forces would move issuers to provide lower valuations and stronger investor protections. So, I saw a walled-garden as inhibiting what investors ultimately wanted—wide choice and the safeguards for quality and safety. Also, I saw a central trust to administer performance stock programs as an unnecessary complication; issuers should be free to choose who administered them.

We debated our perspectives as we explored options to raise more capital. Then, the SEC notified our subsidiary that it intended to rescind its registration as an investment advisor. The reason? We did not qualify to be one because we did not manage member's accounts nor were they paying us for advice! Joseph Heller's novel, *Catch 22*, came to mind. [59] Our business model was to *not be a financial intermediary*—we had no plan to handle anyone's money or stock—instead, we wanted to be a trusted social intermediary.

Clearly, we sought to operate in novel territory. Because it wasn't shared by other regulators, I viewed California to be an outlier whose position could be addressed with time (and expense). By forming our investment adviser subsidiary, we seemingly addressed the underlying concern—that we would facilitate investments without being a regulated entity.

But now, the solution that promised to satisfy (most) states was at risk of being rescinded by the SEC's because *we were not doing* what states were concerned we might be do in the future.

Our round peg did not fit in the federal agency's square hole and state regulators wanted us to find a regulated place for our peg.

We were in a regulatory No-Man's Land.

Why didn't Fairshare want to be a broker-dealer?

Management would have to pass a series of exams that would take time and money to prepare for and maintain.

Also, we would be compelled by a FINRA predecessor, the National Association of Securities Dealers (NASD), to raise capital for reserves and to incur expenses associated with a broker-dealer business that was unnecessary for our "no commission" model.

Indeed, we believed we would be viewed with puzzlement or even hostility by the NASD—either of which would be a hindrance. State and federal regulators already reacted as if I had three legs when I described our business model.

There was no capital requirement to be an investment adviser and supervision was via the SEC, not the NASD, which had conflicts of interest, given its ties to the broker-dealer business.

[59] In Joseph Heller's novel, *Catch-22*, U.S. bomber crews flying over WW II Italy are told they must fly additional missions before they may rotate to safe duty. Increasing cognizant of the risks of being exposed to the ferocious German defenses, Capt. John Yossarian asks the doctor to excuse him because he has become crazy with fear. The rule is that anyone who is crazy is not allowed to fly missions. The doctor explains that he can't excuse Yossarian from flying because of the catch-22 provision which states it is a mark of sanity to be afraid. By claiming to be crazy with fear, Yossarian proves he is sane, for only someone crazy would willing go into such danger.

We entered discussions with an investment group about buying the company. The principal investor was a member of a nationally-known family with powerful political connections. Plus, he had experience in the securities business. He was prepared to re-cast Fairshare as a broker-dealer.

Two days before we were to close, we learned that the SEC was preparing an inquiry into Fairshare's operations. It took 4 months for the investigation to conclude.[60] No action resulted but our prospective buyer had moved onto other things. We ceased operations; all of us went our separate ways.

This may seem quite odd, but even though it failed, I view Fairshare as the most interesting and fulfilling business endeavor I have been involved in. It was more than a business failure…it was a *Magnificent Failure*!

Fast forward a decade.

- The Great Recession triggers a cascade of anxiety about how to spur economic growth.
- Young companies are recognized as job-creating engines.
- Entrepreneurialism is considered "cool", so is innovation.
- Fallout from the slow recovery is expressed as concern and resentment about rising income inequality.
- Online communities have become powerful social networks.
- A lot of money has been raised via crowdfunding.
- Policy sensibilities about capital formation are changing, as witnessed by the JOBS Act.

All these factors lead me to reprise and contemporize the Fairshare Model. A lot of people were intrigued by it. It presents a solution to the valuation challenge; something that will be more apparent as equity crowdfunding grows.

Fairshare may have been too early but today, the Fairshare Model is relevant to economic matters that are on the minds of many.

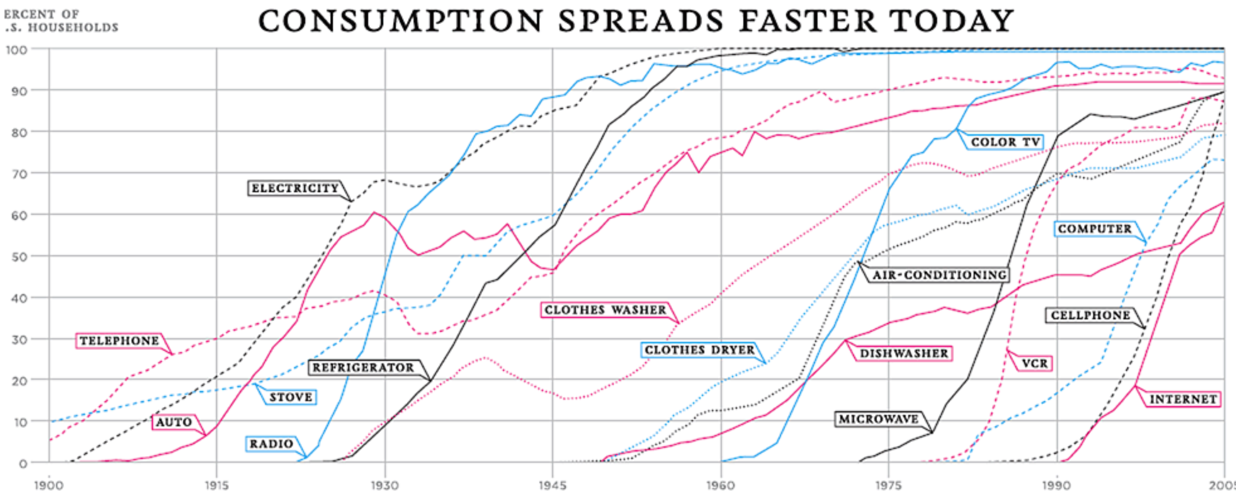
> *There are decades where nothing happens; and there are weeks where decades happen*.
>
> — Vladimir Ilyich Lenin

[60] Our attorney, a former SEC attorney, advised that such investigations usually took at least six months.

How the Fairshare Model will emerge

I believe that variations of the Fairshare Model have the potential to be widely adopted, at least for early stage public offerings. How long will it take?

The chart below shows household penetration between 1900 and 2005 for innovative technologies that start with the telephone and electrification then traverse across a crop of appliances--refrigerators, laundry machines, TV, microwave, etc.—to cell phones and Internet.[61]



It took 25 years for 60% of households to have a clothes dryer. Personal computers took 20 years to reach 60% penetration. The Internet and cell phones took 15 years. Clearly, the time it takes for compelling new devices to be broadly adopted in the mass market is shortening. It takes time for technical innovations to be accepted, longer for traditions to change. How companies structure their ownership interests is, perhaps, one part technical and two parts tradition.

How Companies Structure Ownership Interests = **One Part: Technical Matters** + **Two Parts: Tradition**

The Fairshare Model can help companies raise capital, but that's insufficient to spur adoption. For that to happen, investors and employees need to make money—the more the better. Issuers that use the model must outperform competitors who don't.

On paper, a conventional capital structure has technical vulnerabilities that the model is positioned to exploit, but that's not enough to create change. Tradition must also weaken, which means the Fairshare Model needs multiple successes. That will take years. Then again, each time a valuation bubble pops, interest in the model will be sparked. I see acceptance of the model or variants of it as inevitable—because the problems with a conventional model are profound.

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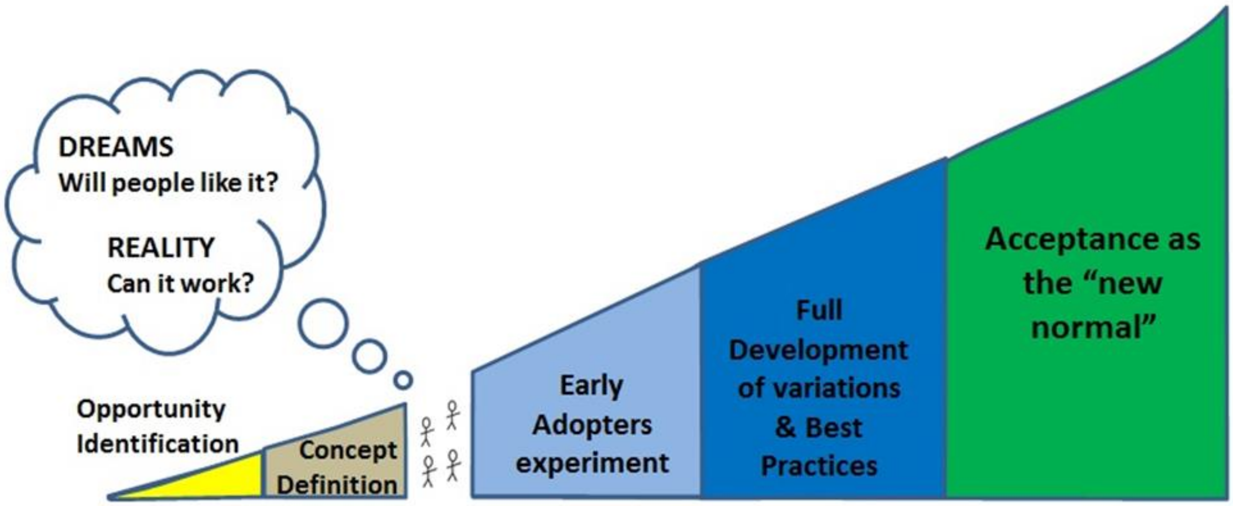
[61] Chart from 2/10/88 New York Times Op-Ed piece, "You Are What You Spend" http://www.nytimes.com/2008/02/10/opinion/10cox.html

The Concept Gap

How might the Fairshare Model become more than an idea? The following chart shows the progression that I anticipate. Below it, each phase is described. The time scale is subject to Hofstadter's Law

Hofstadter's Law
It always takes longer than you expect, even when you take into account Hofstadter's Law.



- Opportunity Identification & Concept Definition
  a. First Try
     i. In the 1980's, John Wilson, begins to think about how to better match up average investors and entrepreneurial companies. Genesis of Fairshare Model.
     ii. In 1994, John and I meet at a Silicon Valley environmental start-up that struggles to find the capital it needs. We determine that his idea isn't feasible.
  b. Second Try
     i. In 1995, the SEC announces that it will cease regulating the *offer of securities* and focus instead on the *sale of securities*, and, that electronic documents are the equivalent of printed ones. State regulators follow.
     ii. John and I form Fairshare, Inc. With the help of a small team in San Antonio and Denver,[62] we develop our message and membership program. We underestimate the challenge of fitting in the regulatory framework. The dotcom and telecom bust dims investor interest in venture capital investing. We go bust.
  c. Third Try
     i. In the wake of the Great Recession, policy makers improve entrepreneurial access to capital. Angel investors are more active and organized. I conclude that Fairshare was too early but we were on the right track. Still, I'm mindful of the risks of being an innovator in this space.

[62] Key work provided by Walter Hodge, Jr., David Alexander, Mary Lou Hodges and Bob Lanari.

- The Concept Gap

    a. If fundamental flaws are identified with the ideas presented in this book, I have the satisfaction of knowing that I had an opportunity to air my perspective and provoke lively discussion.

    b. If the concept has appeal and any flaws are fixable, the Fairshare Model will usher in a new form of capitalism, one that redefines the relationship between labor and capital by balancing and aligning their interests.

    c. The test: a critical mass of interest must emerge (i.e., tens of thousands of people). Such buzz will move companies and financial experts to evaluate it.

- Early Adopters experiment

    a. Early adopter companies raise capital with the Fairshare Model and explore ways to manage Performance Stock.

- Full Development of Variations and Best Practices

    a. Early Adopter companies are studied to gain insight on opportunities, pitfalls, best practices and areas to explore.

    b. Tradition erodes. Venture capital firms advise portfolio firms that need capital and to raise it using the Fairshare Model if they are not home run candidates. Broker-dealers will find ways to make money with it.

- Acceptance as the New Normal

    a. Having established that the Fairshare Model can help companies attract and manage human capital, companies begin to consider the possibility that a conventional capital structure will be potential competitive weakness. A new era in how capitalism is practiced emerges.

Onward

This chapter concludes Section I, which describes the Fairshare Model, the problem with a conventional capital structure, crowdfunding and the history of the model. These have a micro-economic focus.

Section II zooms out to discuss philosophy as well as two macro economic matters—growth and income inequality.

Section III examines valuation—concepts, calculation, evaluation and a call for a valuation disclosure requirement, something that will accelerate adoption of the Fairshare Model.

Section IV has perspective on fraud, failure and tying everything together.

Section II: Context for the Fairshare Model

This section is different from the last one.

Section I was fairly brisk for a reader unfamiliar with capital structures and the jargon that surround them like valuation, pre-money valuation, offering, secondary market, etc. It looked over the capital formation landscape from a metaphoric 1,000 foot level; too high to see details but low enough to see people and their movement. It was broad enough to escape details that need to be addressed before the Fairshare Model moves from theory to practice. It was detailed enough to see the outline of the Fairshare Model and how it might work.

This section moves up to the 40,000 foot level. From that height one can see the curvature of our planet and the topology of the terrain below. It examines broadly shared concerns among all people about economic growth, job creation and income inequality.

The Fairshare Model is a tool to solve the on-the-ground challenge of valuation—a microeconomic problem. It calls into questions the underlying premise of a conventional capital structure—that a value must be determined for future performance at the time of an equity financing. As such, it incidentally raises questions about traditions that rest on the foundation of a conventional capital structure.

So, quite by accident, I realized that this solution to a microeconomic problem sheds light on a new way to think about macroeconomic challenges. One that offers new promise to address large problems because it appears less vulnerable to political disagreement. There is a saying, “where there is agreement on what a problem is, solutions become self-evident”.

So, the music is about to slow done for readers who are not terribly familiar with capital structures—it provides grist for reflection and enlivening conversation about challenges of slow economic growth and rising income inequality.

Many thoughtful people are discussing these issues and this section heavily samples the ideas of others. By doing so, Dear Reader, I hope to contribute to your ability to find connections between seemingly disparate things, just as I mentioned in the second chapter.

Section III will return to a more technical matter—valuation.

Chapters in this section:

- Chapter 8: The Macro-Economic Context –Growth
- **Chapter 9: The Macro-Economic Context – Income Inequality**
- Chapter 10: Cooperation as the New Tool for Competition
- Chapter 11: The Tao of the Fairshare Model

Chapter 8: The Macro-Economic Context –Growth

Preview

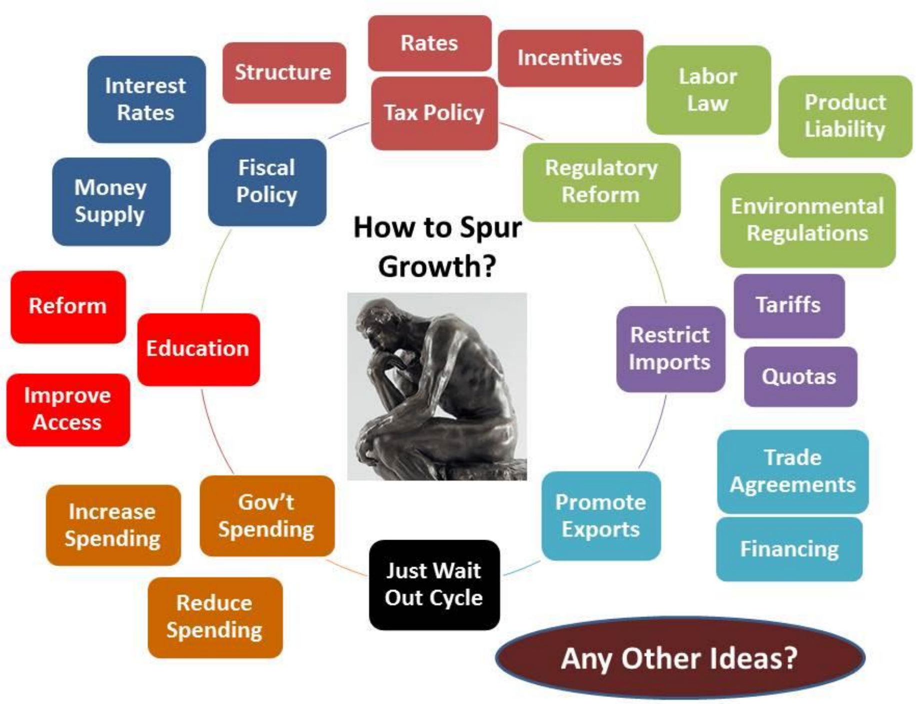
- Foreword
- What policies hold promise to economic growth?
- What About Job Growth?
- Four Prescriptions for Economic Growth
- Another Prescription for Better Capitalism–Restore Dynamism
- Onward

Foreword

The Fairshare Model is a tool to address a micro-economic challenge—how to allow average investors to participate in providing the venture capital that entrepreneurial companies need on terms that approach what professional investors get. It has implications for the macro-economic challenge of spurring economic growth. This chapter considers the macro-economic climate by calling attention to analysis by some distinguished economists on to how to respond to economic crisis.

What policies hold promise to economic growth?

A major challenge facing America, indeed nearly all countries, is how to generate economic growth. Rodin's The Thinker illustrates the basic options available to policymakers.

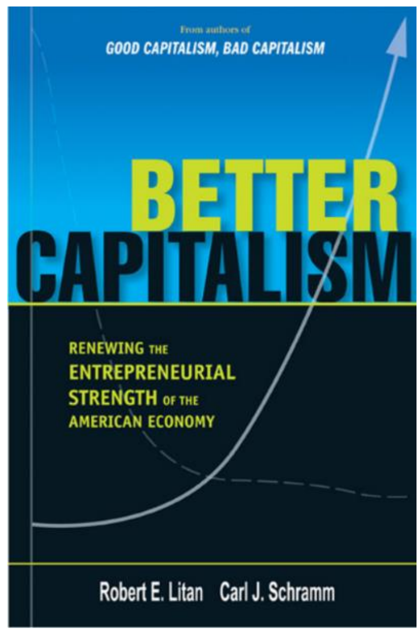


With the exception of import restrictions, each policy avenue has been pursued to some degree since the Great Recession. None have been remarkably effective; this downturn exposed structural issues for which there are no obvious solutions in the playbook of economists. Advocates of any given approach to argue that the right policies haven't been adopted with sufficient vigor. In response, opponents argue that the lack of success is evidence that it's not the right approach at all. Political gridlock about what to do has made "just wait out the cycle" the default response.

So it goes.

How did we get here and what policy initiatives hold the most promise? The following explanation is from Robert E. Litan's and Carl J. Schramm's 2012 book, *Better Capitalism* (bold added for emphasis).[63]

The 1950s and 1960s were the halcyon days of "managerial capitalism," when large firms such as General Motors, Ford Motor Company, U.S. Steel, IBM, and AT&T (in its previous monopoly incarnation), among others, were the driving forces of the U.S. economy. Taking advantage of the pent-up demand for consumer goods during World War II, large firms expanded their reach into new markets at home and abroad. They used their economies of scale, access to internal capital, and in-house research labs to generate new products, drawing on technologies that had been developed during or before World War II. This managerial capitalism delivered rapid growth and thus rising living standards for almost three decades after the end of the war. Indeed, our particular brand of this capitalism was not only envied, but feared. In the late 1960s, European intellectual Jean-Jacques Servan-Schreiber warned European governments and citizens that without aggressive counter-measures, the multinational companies birthed and headquartered in America—the quintessential managerial capitalists—would dominate the world economy.



But then the U.S. economy hit the proverbial wall in the early 1970s. Inflation had been edging up throughout the Vietnam War, eventually leading to a run on the dollar that forced the United States to quit exchanging gold at the price fixed after World War II. Soon thereafter, the fixed exchange rate system that had governed world currency markets and international trade that had been in place since World War II came undone. The coup de grace was the quadrupling of oil prices in 1973, which pushed both inflation and the unemployment rate nearly into double digits—then post-Depression highs. Even though growth later resumed and the unemployment rate fell back to near 6 percent, inflation stayed uncomfortably high until the economy was hit by yet another oil shock, this one in 1979 during the Iranian hostage affair. From 1973 to 1980, stock prices dropped in real terms (adjusted for inflation) by roughly 40 percent, reflecting a loss of

[63] At publication, Litan was vice president for research and policy, Ewing Marion Kauffman Foundation, and a senior fellow in economic studies at the Brookings Institution. Schramm was a visiting scientist at MIT and had been president of the Kauffman Foundation for a decade. Both are fellows of the Bush Institute.

faith in the managerial capitalism that at least until the first oil shock had produced such rapid growth and widely shared prosperity.

There was ample reason for the loss of faith. ***Big Auto and Big Steel—along with steadily Bigger Government—that helped define managerial capitalism proved too bureaucratic and uninventive to withstand the seeming onslaught of cheaper (and often better) imports from Japan and elsewhere. While many Americans feared the United States was thus losing out to the Japanese on the economic front, they had also been steadily losing faith in government.*** *The U.S. military not only suffered its first-ever defeat in Vietnam, but the Watergate scandal that ultimately forced President Nixon to resign shocked Americans of both political parties. The decade ended with the seizure of the American Embassy in Iran and the humiliation of U.S. government employees being held hostage for over a year, unable to be rescued by the one failed military attempt to do so.*

In one narrative, what saved America and rejuvenated its economy was the election of the optimistic, anticommunist, free market enthusiast Ronald Reagan to the presidency in 1980.

Rather than wade into contentious political waters about the correctness of this explanation, we suggest here that an uncontroversial but important contributing reason for at least ***the economic turnaround was the transformation of the U.S. economy from managerial to entrepreneurial capitalism. This apparently new form of capitalism was not new at all, but is in fact what powered the American economy from Revolutionary times until the early 1900s: the cleverness and hard work of waves of entrepreneurs of all types whose efforts gradually lifted the living standards of American citizens.***

Entrepreneurs began to take center stage in the U.S. economy again in the 1970s (before Reagan was elected) with the formation of such companies as Intel, Microsoft, Apple, Federal Express, and Southwest Airlines, among others. But ***entrepreneurial capitalism really took off in the 1980s and 1990s and flowered under presidents of both major parties.***[64]

Also from Better Capitalism

We argue that the "better capitalism" the United States needs now more than ever is one that fosters continuous entrepreneurial revolution*—the economic equivalent of what Thomas Jefferson called for when he famously uttered, "Every generation needs a new [political] revolution."*

Whether or not that statement is appropriate for governing, it could not be more relevant today as an economic proposition. ***For countries at the technological frontier like the United States, sustained rapid growth is only possible through the continued commercialization of new, disruptive—and, yes, revolutionary—technologies, products, and services.*** *We are not sufficiently clairvoyant to predict what those technologies will be. Futurists in the past have missed the mark, and no doubt their heirs today will be equally unsuccessful.*[65]

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[64] *Better Capitalism*, pages 5 to 6
[65] *Better Capitalism*, page 7

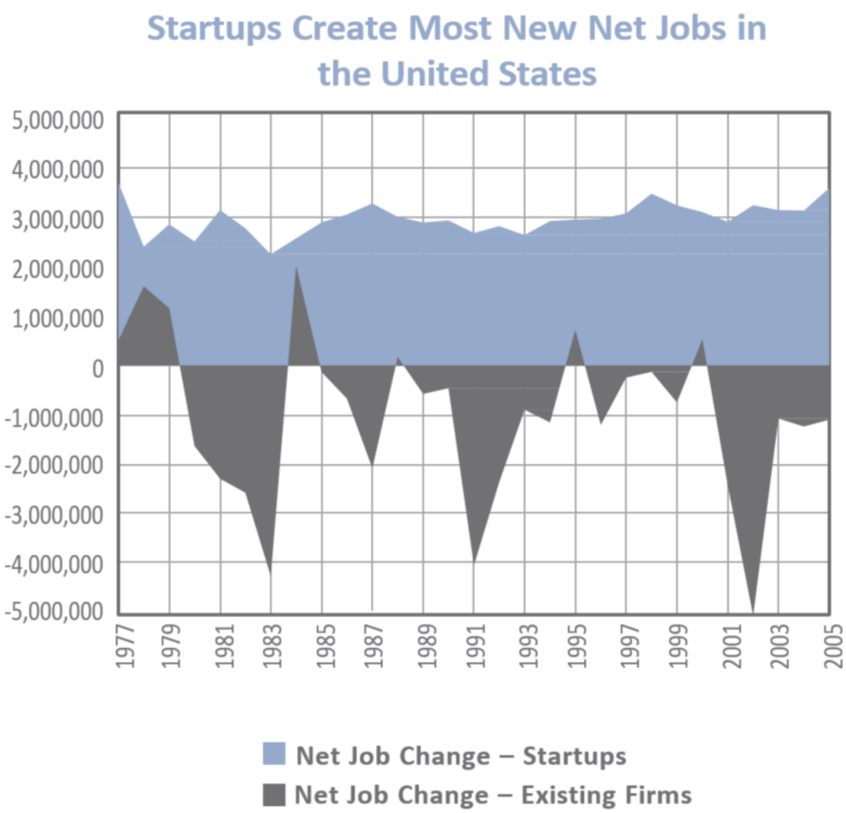
What About Job Growth?

In the late 1990's, I saw a presentation by the head of the U.S. Small Business Administration that said that since the late 1970s, young companies had been responsible for more net job growth than all Fortune 500 companies! My first reaction as "I would not not have thought to compare the two." My second was "amazing!"

More recently, in June 2010, Dr. Tim Kane, senior fellow in Research and Policy at the Kauffman Foundation, authored a report, *The Importance of Startups in Job Creation and Job Destruction,* that made the following statement.

> ***Without startups, there would be no net job growth in the U.S. economy.*** *This fact is true on average, but also is true for all but seven years for which the United States has data going back to 1977.*[66]

The report includes the chart below, which shows startups adding about 3 million jobs each year from 1977 to 2005 and existing firms generally shedding jobs.



There is no obvious solution to the persistent job losses at existing firms. However, it is abundantly clear that start-ups have consistently been a source of good news on this front. One important way to encourage job creation, therefore, is to improve access of small companies to capital.

[66] The Importance of Startups in Job Creation and Job Destruction, by Tim Kane, page 2, http://www.kauffman.org/what-we-do/research/firm-formation-and-growth-series/the-importance-of-startups-in-job-creation-and-job-destruction

Four Prescriptions for Economic Growth—Better Capitalism

The Ewing Marion Kauffman Foundation is one of the largest foundations in the world devoted to entrepreneurship. Its website, www.kauffman.org has a set of engaging video sketchbooks. If you go there and search for "Better Capitalism", you'll see an animated explanation of Litan's and Schramm's four strategic policy initiatives to spur entrepreneurship and reinvigorate long-term economic growth.[67] They are:

1. Encourage immigration by high-skilled foreigners
2. **Improve access to capital for new firms**
3. Speed up commercialization of innovations at universities
4. Regulatory reform

This book, of course, is all about a way to contribute to their second initiative—improve access to capital for new firms, albeit on terms that are better for public investors.

Let's briefly discuss the other three.

Traditionally, the U.S. and other countries have benefited greatly from encouraging immigration by high-skilled foreigners and there is little reason to think that should not continue to be the case. Litan and Schramm write the following in their book.

> *Readers will surely recognize the names of these outstanding immigrants and the companies they founded and helped launch, but we'll bet not many realize that these individuals were all born in other countries: Alexander Graham Bell (AT&T), Levi Strauss (Levi Strauss & Co.), Andrew Carnegie (U.S. Steel), Herbert Dow (Dow Chemical Company), E.I. du Pont (DuPont), Charles Pfizer (Pfizer), David Buick (Buick Motors, later purchased by General Motors), Adolph Coors (Coors Beer), Henry Heinz (H.J. Heinz Company), James Kraft (Kraft Foods), William Proctor and James Gamble (Proctor & Gamble), Eberhard Anheuser and Adolphus Busch (Anheuser-Busch), Samuel Goldwyn and Louis Meyer (MGM), Marcus Goldman (cofounder of Goldman Sachs), and even Ettore Boiardi (Chef Boyardi). Add Sergey Brin (Google), Andrew Grove (Intel), Jerry Yang (Yahoo!), and Pierre Omidyar (eBay).*[68]

President Barack Obama made a similar point when advocating for congressional action on immigration reform.

> *In recent years, one in four of America's new small business owners were immigrants. One in four high-tech startups in America were founded by immigrants. Forty percent of Fortune 500 companies were started by a first- or second-generation American. Think about that — almost half of the Fortune 500 companies when they were started were started by first- or second-generation immigrants. So immigration isn't just part of our national character. It is a driving force in our economy that creates jobs and prosperity for all of our citizen.* [69]

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[67] Link to sketchbook http://www.kauffman.org/multimedia/sketchbook/kauffman-sketchbook-better-capitalism

[68] *Better Capitalism*, by Robert Litan and Carl Schramm, page 110

[69] From President Barack Obama's June 11, 2013 remarks on immigration reform"

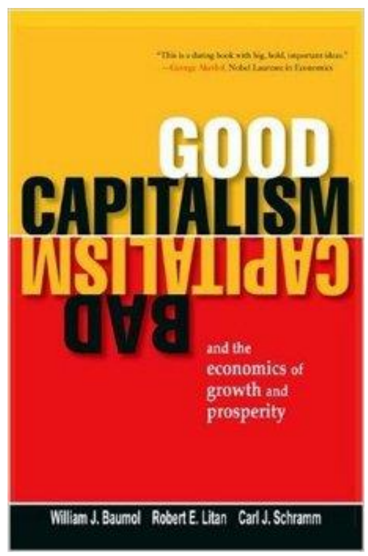
The Fairshare Model complements implementation of Litan's and Schramm's third recommendation—speed up commercialization of innovations at universities—because it could help improve access to capital by start-ups that license technology. A university might accept some payment in Investor Stock and/or a position in a licensee's Performance Stock.

The fourth recommendation, regulatory reform, is beyond the scope of this book. I will say, however, that companies in a financial turnaround situation must rethink strategy and processes. The same is true for nations in an economic turnaround. Starting in 1991, Japan's theretofore highly successful economy entered recession. Its failure to address regulatory reform are a major reason why many problems persist, nearly a quarter century later.

Better Capitalism, was published in 2012 as the sequel to a book that Litan and Schramm issued with William J. Baumol in 2007, *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity*. *Better Capitalism* was written because the world changed dramatically shortly after *Good Capitalism, Bad Capitalism* came out and the authors felt "we need an even stronger dose of entrepreneurial capitalism" than first proposed.

Here is an excerpt of a review of *Good Capitalism, Bad Capitalism* that was in the July 7, 2007 edition of *The Economist*, a few months before the collapse of Lehman Brothers, the investment bank that heralded the financial crisis *(bold added for emphasis)*.

The fall of the Berlin Wall in 1989 may have proved once and for all that capitalism is better than communism, but it did nothing to settle the debate about which model of capitalism is the best. Or, to be precise, the debate about whether the American model will continue to outdo all comers, or instead be replaced at the top of the economic heap by a rival.



"Good Capitalism, Bad Capitalism" helpfully moves the debate on from competing national models to the underlying structures that shape the relative effectiveness of different sorts of capitalism. Written by three economists, including 85-year-old William Baumol, arguably the leading thinker about the economics of innovation since Joseph Schumpeter [an Austrian economist of the first half of the 20th century], it identifies four main varieties of capitalism.

1. *State-guided capitalism, in which government tries to guide the market, typically by supporting certain industries that it expects to become "winners".*

2. *Oligarchic capitalism, in which the bulk of the power and wealth is held by a small group of individuals and families.*

3. *Big-firm capitalism, in which the main economic activities are carried out by established giant enterprises.*

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http://www.politico.com/story/2013/06/obama-immigration-reform-transcript-video-92578.html#ixzz2VwL0s4Vr

4. Entrepreneurial capitalism, in which a major role is played by small, innovative firms.

The only thing that all four of these models of capitalism have in common is that they recognize the right of private property ownership.

Nor is there any single country that has exactly any one of the models described; in most national economies there is some blend of at least two. Moreover, the blend changes over time, and with it, the performance of the economy. Less than two decades after the fall of communism, Russia is already moving rapidly from oligarchic capitalism to an authoritarian state-guided capitalism.

What works best, argue the authors, is a mix of big-firm capitalism and entrepreneurial capitalism. And this happens to describe America's economy during the past 20 years, during which h time it has reversed its seemingly inevitable long-term decline and delivered a "productivity miracle".

***The possibility of change is at the heart of "Good Capitalism, Bad Capitalism".** The authors are skeptical—for the most part, plausibly—of claims that the growth rates of economies are largely predestined by culture or geography, as books such as "The Wealth and Poverty of Nations" by David Landes or Jared Diamond's "Guns, Germs and Steel" suggest. There are no quick fixes, but over time the right policies can make a big difference, as can the wrong policies.*

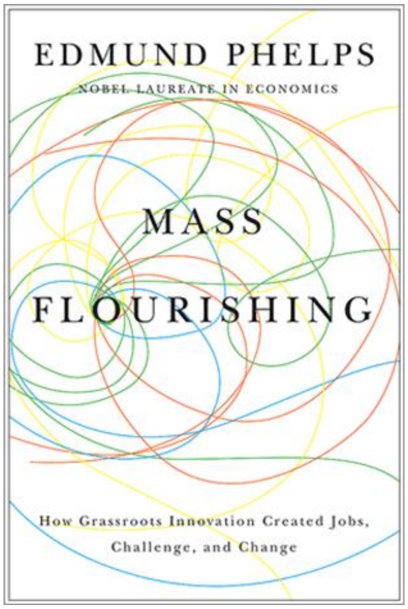
*The authors argue that continental Europe and Japan, currently dominated by big-firm capitalism, can increase the role of entrepreneurial capitalism—perhaps, ironically, by learning from the incremental approach to reform of the Chinese government. And **America, they say, is in danger of stifling its own entrepreneurial capitalism through the same increased regulation and risk-aversion that led to the dominance of big-firm capitalism in America in the 1960s and 1970s. If so, it risks losing its capitalistic crown, not as a result of any external threat, but through its own fault.*** [70]

> *It was Karl Marx, capitalism's most famous critic, who coined the word "capitalism".*
>
> *It described an economic system he believed was dominated by a few "capitalists"—owners of buildings, equipment and the dreaded corporations—whom he believed exploited the masses.*
>
> *But Marx the wordsmith was cleverer than Marx the economist. The emerging economic system that he decried for enslaving the poor turned out instead to be the greatest anti-poverty force the world has ever known, lifting living standards for ever-growing numbers of people beyond what they could have imagined.*
>
> -- From *Better Capitalism*, by Robert Litan and Carl Schramm

[70] America still wears the crown, *The Economist*, Jul. 5, 2007, http://www.economist.com/node/9433839

Another Prescription for Better Capitalism–Restore Dynamism

A broader, more elemental perspective on economic woes comes from Professor Edmund Phelps of Columbia University, who is also director of its Center on Capitalism and Society.[71] Dr. Phelps' is a Nobel laureate; he was awarded the economics prize for work on unemployment and microeconomics.



His 2013 book, *Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge and Change*, presents a wide-ranging assessment on what leads economies to thrive. His diagnosis of what's wrong with the economy is fundamental and delivered in a genteel manner; he strikes me as a mild mannered version of the Howard Beale character in the movie *Network* (mentioned in chapter one).

Professor Phelps emphasizes the importance of dynamism—the willingness and capacity of an economy to innovate—a quality he says that has been in decline for decades for two reasons. The first is a rising hostility to what he calls "modern values." The second is movement away from a modern notion of the Aristotelian concept of the "good life" and toward a self-destructive fixation on money-making and materialism.

Before elaborating on his thesis, let's get the politics out of the way. Some of what he says appeals to the political left and some of it is off-putting to them. The same is true for those on the political right. His view is disorienting to anyone who views problems and solutions through a political prism. In part, because both ends of the spectrum benefit from what he sees as a key problem—corporatism. It is an uncommon word that refers to the control of a state or organization by large interest groups. Phelps sees the Democratic Party pursuing corporatism that goes well beyond the New Deal or Great Society. He despairs at the Republican enthrallment of "traditional values", values that suppress individual self-expression, which he associates with a rise in materialism and a desire to amass wealth. He also wants to move beyond the superficial argument that freedom will return economies to those of the past.

There is pervasive use of "modern" in *Mass Flourishing*; modern era, modern society, modern economies and modern values, attitudes and beliefs. This word generally means relating to the present time or using recent ideas or designs but Phelps embraces another meaning—the untraditional, novel, disruptive or even subversive.

The tableau Phelps works with begins in antiquity and he says "some ideas that we think of as modernist existed in ancient times but were not widespread or they were driven out in the middle ages." He relies on Jacques Barzun's 2000 book, *From Dawn to Decadence*, to mark the beginning of the *modern era* around 1500, with the start of the European Renaissance. And, he refers to 1815, after Napoleon's defeat at Waterloo, as the start of *modern society*. In his 1991 book, *The Birth of the Modern*, Paul Johnson argues that "the matrix of the modern world was formed then: the U.S. became a global power, Russia

[71] http://capitalism.columbia.edu/

expanded rapidly, Britain penetrated the Middle East, Latin America threw off Spain's yoke, and an international order which would endure for a century took shape."[72]

Modern economies are what emerged first in Britain, then America, followed later by France and Germany. Somehow, the economies of these nations developed *dynamism*—the appetite and capacity for *indigenous innovation* (i.e., homegrown, as opposed to copied from another country). What followed was a breakout of prosperity that fired imaginations and transformed working lives. The emancipation of women and abolition of slavery widened the flourishing. The creation of new methods and new products was driven at least as much by business people—entrepreneurs, financiers and marketers—and pioneering end-users as by scientists. In talks about his book, Phelps says "The epic story of the West is the development in the 19th century of a mass prosperity the world had never seen and its near-disappearance in one nation after another in the 20th."[73]

Modern values, Phelps writes, are the attitudes that began to be formulated in the modern era, accelerated with modern society and are the foundation of a modern economy. They remain prevalent in Western nations, even though they differ significantly by country. Examples of modernist values are:

- Thinking and working for yourself;
- Self-expression;
- Readiness to accept change caused or desired by others;
- Eagerness to work with others;
- Desire to test one's self against others, thus to compete; and
- The willingness t take the initiative, thus go first.

"*Modern attitudes* are the desire to create, explore and experiment, the welcoming of hurdles to surmount, the desire to be intellectually engaged, and the desire to have responsibility and to give orders. Behind these desires is a need to exercise one's own judgment, to act on one's own insights, and to summon up one's own imagination. This spirit does not involve a love of risk. It is a spirit that views the prospect of unanticipated consequences that may come with voyaging into the unknown as a valued part of experience and not a drawback. Self-discovery and personal development are major vitalist values. "

"*Modern beliefs* include some distinctive ideas about what is right; the rightness of having to compete with others for positions of higher responsibility, the rightness of greater pay for greater productivity or responsibility, the rightness of orders from those in responsible positons and the rightness of holding them accountable, the right of people to offer new ideas, and the right of people to offer new ways of doing things and to offer new things to do. All this stands in contrast to traditionalism with its notions of service, obligation, family and social harmony."[74]

Phelps says Western nations lost half or more of their dynamism in the 20th century: Britain and Germany in the 1940s, France in the early 1960s and America in the 1970s. He is skeptical the ability of the technology sector to raise the economy because its financial benefits are concentrated geographically, like in the San Francisco Bay area, and the revenues from many such innovations are insubstantial. What's needed, he believes, is an approach that has broader impact on more sectors of the economy.

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[72] Publisher's description.
[73] "Mass Flourishing: How It Was Won, Then Largely Lost", lecture delivered by Phelps Oct. 9, 2013
[74] The description of modern values, attitudes and beliefs are from *Mass Flourishing*, pages 98 - 99

Mass Flourishing identifies institutions and policies that block innovation; short-term perspective in big business and finance, under-taxation that gives people inflated perceptions of their wealth and a minefield of patent and regulatory risks. But Phelps says a more fundamental problem is that the desire to innovate has been dampened by waning belief in modern values and a rise in traditional values. He advocates a re-embrace of modern values because they encourage the innovation that people need in order to thrive and when they thrive, economic output and satisfaction are likely to improve.

The book defines innovation as new knowledge that leads to new practices. Phelps points out that scientists and engineers tend to view innovation as new knowledge, assuming that it will lead to new practices. Economists view the new knowledge and its adoption as two different phenomena. Thus, he recognizes the importance early users have in economic innovation.[75] Alternatively, he makes the point by saying that innovations (an innovative society) depends on a system—innovative people and companies are just the beginning. There must be people with the ability to judge well whether to attempt to develop or to finance a new thing. And, once the new thing is developed, whether it is worth trying. Theses ideas are in these conceptual equations.

Innovation = New Knowledge that Leads to *New Practice*

New Practice = Origination of New Thing (concept & development) + Pioneering Adoption

Embrace of New Practices = Dynamism = Modern Society = Modern Economy

Let's return to Phelps' use of the word *dynamism*, a quality that leads to innovation. He describes it as the willingness and capacity to innovate, leaving aside current conditions and obstacles. He points out that the distinction between innovation and imitation is fuzzy. That nations historically relied on their own ability to innovate (indigenous innovation), but, increasingly, they adopt innovation originated elsewhere (exogenesis innovation).

Phelps uses this insight to distinguish economic dynamism from economic *vibrancy*, which is the alertness to opportunities, a readiness to act. Then, he states that *the economic growth rate is NOT a useful measure of dynamism*. In fact, an economy with little or no dynamism may regularly have the same or better growth in productivity and/or real wages that a dynamic one has. How? Partly, by trading with a dynamic economy, but, mainly, by being vibrant enough to imitate the new practices of a dynamic economy. In fact, an economy with low dynamism might for a time show a faster growth rate that a modern economy does with its high dynamism.

[75] This underscores, Dear Reader, how critical buzz about the Fairshare Model is to its adoption by pioneering entrepreneurs.

Interestingly, he suggests three ways that the effect of dynamism in an economy might be measured; consider the forces and facilities that are its inputs, estimate its output and assess circumstantial evidence of its strength.[76] These approaches are below.

1. **Consider the strength of the forces and facilities that are its inputs**

   - Drive to change things
   - Talent to change things
   - Receptivity to new things, and
   - Institutions that enable change

2. **Estimate its output**

Start With	Gross Domestic Product growth that is NOT due to growth in the supply of capital or labor
Add or Subtract	Unusual market conditions
Subtract	"False innovations"--innovations that originate in other countries and copied; from a global perspective, this does not reflect innovation
Equals	Growth in income earned from an economy's indigenous dynamic qualities

3. **Assess circumstantial evidence**

   - New company formation
   - Employee turnover (i.e., higher turnover = higher dynamism)
   - Turnover in the list of large companies in an economy
   - Turnover of retail stores
   - Mean life of universal product codes (UPC bar codes)

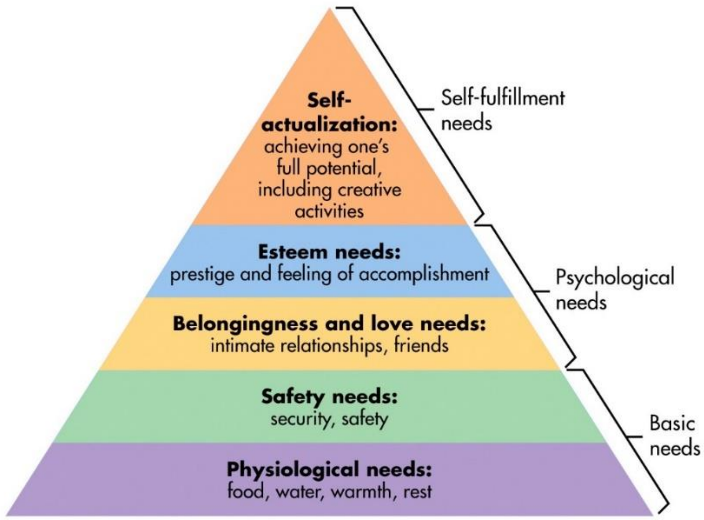
So, if an economy with little or no dynamism can have growth that equals or even exceeds one that has, and, if economic dynamism risks disruption, why encourage it? Phelps argues persuasively that it is positively correlated with growth while acknowledging that dynamism can result in bad luck. But he emphasizes that the central reward of a modern economy is that its participants have the opportunity to pursue the Aristotelian concept of the Good Life. Conceptual expressed here:

Modern Beliefs, Attitudes and Values → Modern Economy → "The Good Life"

The ancient concept of The Good Life	**=**	**The *intellectual growth* that comes from actively engaging the world**	**+**	**The *moral growth* that comes from creating and exploring in the face of great uncertainty**

[76] *Mass Flourishing*, page 21

Singer Tony Bennett popularized a song about romance called *The Good Life* that includes the line "It's the good life to be free and explore the unknown." That reflects a sentiment that Phelps says Aristotle had in mind about what made a life fulfilling and, by extension, what makes an interesting job satisfying. For him, the good life as something that people would choose once their need for essentials were comfortably met. A similar notion was expressed by 20th century psychologist Abraham Maslow in his theory of human motivation, illustrated in the diagram below. Maslow's hierarchy of needs has self-actualization—a form of the good life—as the highest need, sought once other lower ones are satisfied.



Because some money making is forced on society, Aristotle likely felt that the good life was a luxury for the elite and not easily in reach by the less fortunate, but Phelps believes that the good life was accessible to those at the bottom rungs of society. He points out that there is little reason to conclude that slaves lacked desire or capacity for the highest good and that Aristotle's own teacher, Plato, may have been sold into slavery.

Mass Flourishing highlights the thoughts of many thinkers over the ages on variations of what brings people the greatest satisfaction in life. The most succinct expression of this doctrine of "vitalism" may be "to boldly go," NASA's motto in the early days of the project to go to moon (and in the Star Trek television show). Phelps' adds this:

> "The difference between the pragmatist take on the good life and the vitalist take is striking. The word 'hurdle' is in the lexicon of both schools, but hurdles come up in contrasting ways. In the vitalist view, people are *looking for* hurdles to overcome, problems to solve: if you do not happen to meet any, you change your life so that you start meeting them. In the pragmatist view, people *encounter* hurdles in the course of being pragmatic—of working in an industry or profession that seems to offer the best prospects of success. Pragmatists do not specify what human kind wants to succeed at. They only say that, whatever a person's career is aimed at, the person—unless very unlucky—will meet innumerable problems and solve a great many of them. Their *engagement* in problem solving is an intellectual side of the good life. The resulting mastery is another part of the good life: the part called *achievement*."[77]

[77] Mass Flourishing, pages 283-284

Phelps argues that "vitalism is enjoying a revival after decades of pragmatism," then considers how Aristotle might apply *eudaimonia*, ancient Greek for happiness or flourishing, to contemporary times. He cites research "that many Americans want to feel embarked on a mission to *make a difference*."[78] So, what constitutes a vibrant one? Phelps posits that:

> "A society seeks and builds an economy to provide mutual benefits for its citizens. So, as a life in pursuit of the highest good, or benefit, is termed by Aristotle the 'good life,' an economy enabling people's mutual pursuit of the highest good may be termed a *good economy*. An economy is good if and only if it permits and fosters the good life."[79]

What can be done to restore economic dynamism? Phelps sees an important role for government at all levels, provided it rescinds old interventions at least as actively it initiates new ones. He also makes the following recommendations [80]

- Government must be aware of the importance of dynamism in a modern economy.
- To take well-judged actions, governments must have a sense of the way forward. They have to have an elementary understanding of how the business sphere of a well-functioning modern economy generates dynamism. It is not mechanical: it is organic. It is not an ordered system: it is topsy-turvy. Legislators and regulators should ask of every bill or directive: "How would it impact the dynamism of our economy?"
- Policy makers should disabuse themselves of the notion that economic growth is increased by policies that stimulate some industries over others through subsidies, mandates, private-public partnerships or government-sponsored enterprises.
- Shrink or terminate policies that promote a corporatist economy; much special interest legislation exists in the form of tax deductions, exemptions and carve-outs. "The U.S. tax code runs to 16,000 pages. The French have a tax code with only 1,900 pages."[81]
- Stop paying CEOs very high short-term salaries as this induces short-term thinking. Corporations should not be able to use their capital for golden parachute payments.
- Don't allow mutual funds to threaten a CEO with dumping her company's stock if she doesn't fix her attention on hitting the next quarter's earnings target.
- Overhaul the banking industry to provide vastly more credit for innovative projects and start-ups. Specifically, restructure the behemoths into smaller units with narrower lines of business, leaving risky assets to markets with the appropriate expertise.
- Reexamine the ability of labor unions and professional associations to inhibit innovation or restrict new entrants into markets.
- Reintroduce to secondary and higher education the main ideas of modern thought, such as individualism and vitalism (i.e. a creative and venturesome spirit).[82]

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[78] *Mass Flourishing*, page 285
[79] *Mass Flourishing*, page 288
[80] These recommendations are discussed in pages 316 to 324 of *Mass Flourishing*
[81] *Mass Flourishing*, pages 164-165
[82] Exposure to Greek and Roman mythology and philosophers, adventure novels, etc.

Onward

The question of how to invigorate economic growth is a large one and it's easy to find an array of views on how to answer it.

The distinguished economists cited in this chapter are not ideologues and they straddle the macro- and micro-economic spheres. They share the idea that the weak U.S. economy calls for something different. Robert Litan and Carl Schram narrow their recommendations to immigration reform, improved access to capital, more rapid commercialization of university intellectual property and regulatory reform. Edmund Phelps' goes long and broad, making the case to restore the dynamism that leads to innovation.

The Fairshare Model is about improving access to capital for venture stage companies. Such companies play an outsized role in America's economic growth, its ability to engage in mutually beneficial trade with other nations and to create engaging, fulfilling jobs. It's also about fostering an innovative social compact between investors and workers.

Often, a risk assumed does not have a favorable outcome. Its the nature of things, but its the essence of being to assume risks. Venture stage companies are inherently risky. Entrepreneurs are more likely to fail than succeed. The cost to them can come from foregoing stable employment, loss of capital, increased debt and lost time. The struggle can fray personal relationships and create a stigma of failure. But still many try. Venture investors are more likely to lose money than make any, but there are many, including those who are non-accredited, who want to provide it. Many who have had success have also suffered losses; some who have had little or no success continue nonetheless. Early adopters of a technology often pay a price for being in the first wave, but they are willing to take the leap. A bad outcome can be the nature of things, but so is hope.

Dear Reader, I hope you see the potential benefit to the economy of making it easier to responsibly provide better access by entrepreneurial companies to Middle Class investors, and vice versa. That it is possible to view this activity apart from the prospect to make money--to see it as a pursuit of The Good Life. As an expression of support by investors to an obsessive entrepreneurial team with a quirky idea that is unlikely to generate a financial return for investors. They are all dreamers of what may be possible and their existence is a vital asset to the economy.

And if the investment doesn't pay off, so what? So long as the investor didn't invest more than he or she could afford to lose, didn't overpay and wasn't mislead, its possible that the investor was in pursuit of The Good Life. The lessons learned may make success more likely down the road.

A later chapter will discuss fraud. But for now, reflect on the how this activity could help the economy restore its innovative engine, strengthen its *mojo (i.e.,* a power that may seem magical and that allows someone to be very effective, successful, etc.).

> *It is only in adventure that some people succeed in knowing themselves—in finding themselves.*
>
> -- Andre Gide

The next chapter explores the implications of the Fairshare Model for another macro-economic issue---income equality.

Chapter 9: The Macro-Economic Context – Income Inequality

Preview

- Foreword
- Piketty's R > G
- Conservative Perspectives on Income Inequality
- Another Take: R > L
- Common Ground?
- Is the Fairshare Model Capitalism?
- Economic Justice in the New Issue (IPO) Market
- Onward

Foreword

Income inequality--all view it as the handmaiden of slow economic growth. Increasingly, the view has emerged that it also reflects a system that is gamed to favor the wealthy and connected. At another level, it's a discussion about how to promote the best society. It has become a hot-button issue.

The Fairshare Model presents a *partial* solution, in that the benefits only go to those with "skin in the game"; those who invest in or work for a company that raises capital using the model. This is a narrow group, and, only some who provide capital and labor to companies that use the model will have a good result.

The model's solution is to expand the opportunity for those who rely on the return on their labor to participate in the return on capital. That is, make it easier for non-accredited investors who invest in companies that use the Fairshare Model and those who work for them to earn income from capital gains. Its an idea about how to address income inequality that may have broad political appeal. Not so much for the effect it will have in the next few years, but in a generation or two, once it becomes the New Normal for how companies raise public venture capital.

This solution is discussed at the end of this chapter. Before then, we'll consider the phenomena of rising income inequality from a range of perspectives.

Piketty's R > G

In 2014, French economist Thomas Piketty published *Capital in the 21st Century*, which examines how income has been distributed in capitalistic economies. This summary is from *The New Yorker*:[83]

> *Using tax records and other data, he studied how income inequality in France had evolved during the twentieth century, and published his findings in a 2001 book. A 2003 paper that he wrote with Emmanuel Saez, examined income inequality in the United States between 1913 and 1998. It detailed how the share of U.S. national income taken by households at the top of the income distribution had risen sharply during the early decades of the twentieth century, then fallen back during and after the Second World War, only to soar again in the nineteen-eighties and nineties.*
>
> *With the help of other researchers, Piketty expanded his work on inequality to other countries, including Britain, China, India, and Japan. The researchers established the World Top Incomes Database, which now covers some thirty countries. They also updated their U.S. figures, showing how the income share of the richest households continued to climb during and after the Great Recession, and how, in 2012, the top one per cent of households took 22.5 per cent of total income, the highest figure since 1928.*

The book's central argument captured considerable attention; that the growth in the size of the Middle Class in the 20th Century was a historic anomaly and rising income inequality is a return to normalcy. In other words, income inequality has been a persistent economic reality. And, the 20th Century experience of a large and growing Middle Class was a remarkable phenomenon that is unlikely to persist. Professor Piketty uses this formula to explain why:

Return on capital > Growth in the economy

expressed as

R > G

The formula means that the rate of Return on Capital (abbreviated as "R" in the side chart) has tended to exceed the Growth Rate in the Economy (abbreviated as "G").[84]

Piketty's measurement period is about two thousand years--year 0 to 2012. Over this time, he concludes that R has averaged 4 to 5% per year and G has been about zero, 0.1%.

Over a long period of time, the difference in income magnifies. In part, because it is accumulated, in the form of wealth. In part, because wealth that is invested earns the higher rate of return, R. In

[83] Forces of Divergence, By John Cassidy, *The New Yorker*, Mar. 31, 2014 http://www.newyorker.com/magazine/2014/03/31/forces-of-divergence

[84] The *PBS News Hour* used this chart to explain Piketty's theory in its May 2014 report "Gaming Mr. Darcy: What Jane Austen Teaches Us About Economics" http://www.pbs.org/newshour/making-sense/gaming-mr-darcy-what-jane-aust/.

contrast, those whose income is chiefly derived from their labor see their income grow at the lower rate, G. Thus, the formula neatly explains why the rich get richer over time. The components of the two rates are identified below.

R = Return on capital = Interest + Dividends + Capital Gains + Rent Payments

G = Growth in the economy = Productivity Rate X Change in Population Size

The components of R are straight-forward; interest dividends and capital gains. The components of G merit explanation, however.

It's intuitive to associate productivity with growth. When the productivity rate climbs, so does economic growth. The reverse effect is also clear.

Less obvious, is why an increase in population promotes economic growth or why a decrease in population vice versa contributes to a shrinking economy. It happens because people naturally find ways to make economic transactions to support themselves—the best that they can, anyway. An increase in the number of people transacting for food, clothing, shelter and so on contributes to an increase in economic activity. It works the opposite way when population shrinks; a reduction in the number of people making such transactions contributes to a decline in economic growth.

Piketty's Political Proclivity

PAUL SOLMAN (PBS News Hour): … Thomas Piketty's recent U.S. press tour was likened to Beatlemania, with standing-room-only events. Nobel laureates on stage with him piled on the praise especially ones tilting [politically] left, who share concern for the global trend the 42-year-old Parisian has definitively documented: growing economic inequality.

So our first question, when we sat down with him, was about his political slant.

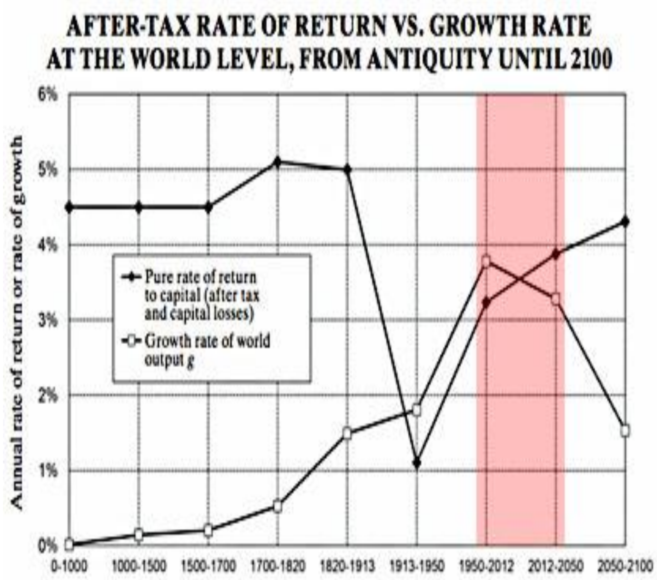
Capital—*Capitale*—the name of Karl Marx's famous work, so are you a French Marxist?

PIKETTY: Not at all. No, I am not a Marxist. I turned 18 when the Berlin Wall fell, and I traveled to Eastern Europe to see the fall of the communist dictatorship. And, you know, I had never had any temptation for communism or, you know, Marxism.

From the *PBS News Hour*, May 12, 2014

A liberal and a conservative economist debate Piketty's theory in a News Hour segment "Why do the rich get richer?" at http://www.pbs.org/newshour/bb/piketty-takes-on-inequality-in-capital/

This chart illustrates Piketty's long-view findings about R and G, starting in Year 0 and projected to the end of the current 21st century. The return on capital after taxes and loss of capital (due to fire, war, spoilage, etc.), R, is the line that begins at the 4.5% mark represents. The line that begins at zero is G, the growth rate of the world's economic output.



The rate of return to capital (after tax and capital losses) fell below the growth rate during the twentieth century, and may again surpass it in the twenty-first century.

Note that time on the horizontal axis is in irregular blocks.[85]

For the first 1,500 years, from year 0 through the Roman Empire and the end of the Middle Ages, the return on capital (R), averages 4.5%. Around 1500, sparked by the discovery of the New World and the European Renaissance, it enjoys a 200 year climb to about 5%. [In the last chapter, 1500 was identified as the start of the Modern Era.] From 1700 to 1820, the birth of Modern Society, it remains steady. Then, it plunges to 1% between 1913 and 1950, the result of the First World War, the Great Depression and the Second World War; capital assets were destroyed or consumed in the wars and devalued in the interwar period.

Turn now to the economic growth rate (G). It hovers above zero from year 0 to 1500, an epoch defined by rising agricultural productivity and growth in mercantile trade. It climbs significantly, up to 0.5% over the first 320 years of the Modern Age (1500 to 1820). Then, with dawn of Modern Societies and Modern Economies , it triples to 1.5%. This is the start of what Edmund Phelps—based on unrelated analysis—characterized as an age of mass flourishing. Pushed by productivity improvements that emerge during the Industrial Revolution, economic growth continues to increase to nearly 2% before WW I. Note that for the first time, G exceeds R; economic growth is greater than the return from capital by about 0.75% per year.

During the postwar period, 1950 to 2012, R and G climb nearly in tandem. Economic growth is nearly one percent higher than the return on capital in 1950, but the advantage erodes by 2012. More significantly, economic growth, the factor that enabled the formation of a large and growing Middle Class in America, grows to about 3.9%, a historic high.

Piketty speculates how these trends will play out over the 21st century. Absent adoption of tax policies that tax capital gains and inherited wealth at higher rates, or, tax rates on income from salaries and wages at lower rates, he thinks that it's likely that R, the return on capital, will begin to exceed G, economic growth. This occurs in the shaded portion of the graph, midway between 2012 and 2050.

[85] The first vertical line marks returns between year 0 and 1000 (1,000 year period). Subsequent ones marks returns between 1000 and 1500 (500 years later), between 1500 and 1700 (200 years later), between 1700 and 1820 (120 years later), between 1820 and 1913 (97 years later); between 1913 and 1950 (47 years later); and between 1950 and 2012 (62 years later) before projecting the balance of this century.

After that, between 2050 and 2100, his model shows the return on capital will continue to grow toward the pre-Renaissance norm. And, economic growth will slide from its 2012 peak of 3.8% to the 1.5% last seen before 1820 (i.e., the start of modern economies).

He anticipates rapid expansion in the use of non-human producers of economic output—computers, robots or biological processes—plus, decline in population size. Absent changes in tax policies, Piketty expects that the economic benefits generated by non-human forms of production will disproportionately go to the owners of capital.

With respect to his historic analysis, economists on all points of the political spectrum express admiration. Some disagree with his dystopian projection for labor and there is a predictable divide on his prescription for higher taxes on the wealthy. Piketty reports that Microsoft founder Bill Gates told him "I love everything that's in your book, but I don't want to pay more tax." Recognizing the charitable work that the Bill and Melinda Gates Foundation does, and the efficiency with which it operates, Piketty said "I understand his point. I think he sincerely believes he's more efficient than the government, and you know, maybe he is sometimes." [86]

In his personal blog, Gates encourages others to read Piketty's book or a good summary.[87] Below are some of the points that he makes in the full piece:

> *"I [Bill Gates] agree with Piketty's most important conclusions, and I hope his work will draw more smart people into the study of wealth and income inequality. I very much agree that:*
>
> - *High levels of inequality are a problem—messing up economic incentives, tilting democracies in favor of powerful interests, and undercutting the ideal that all people are created equal.*
> - *Capitalism does not self-correct toward greater equality—that is, excess wealth concentration can have a snowball effect if left unchecked.*
> - *Governments can play a constructive role in offsetting the snowballing tendencies if and when they choose to do so.*
>
> *Extreme inequality should not be ignored—or worse, celebrated as a sign that we have a high-performing economy and healthy society. Yes, some level of inequality is built in to capitalism. The question is, what level is acceptable? And when does it do more harm than good? That's something we should have a public discussion about, and it's great that Piketty helped advance that discussion in such a serious way.*
>
> *At the core of his book is a simple equation: r > g, where r stands for the average rate of return on capital and g stands for the rate of growth of the economy. The idea is that when the returns on capital outpace the returns on labor, over time the wealth gap will widen between people who have a lot of capital and those who rely on their labor.*

[86] "Thomas Piketty: Bill Gates Told Me He Doesn't Want To Pay More In Taxes", by Maxwell Strachan, Jan. 05, 2015, Huffinton Post, http://www.huffingtonpost.com/2015/01/04/piketty-bill-gates_n_6413446.html
[87] "Why Inequality Matters", by Bill Gates, Oct. 13, 2004, http://www.gatesnotes.com/Books/Why-Inequality-Matters-Capital-in-21st-Century-Review

Other economists have cast doubt on the value of r > g for understanding whether inequality will widen or narrow. I'm not an expert on that question. What I do know is that r > g doesn't adequately differentiate among different kinds of capital with different social utility.

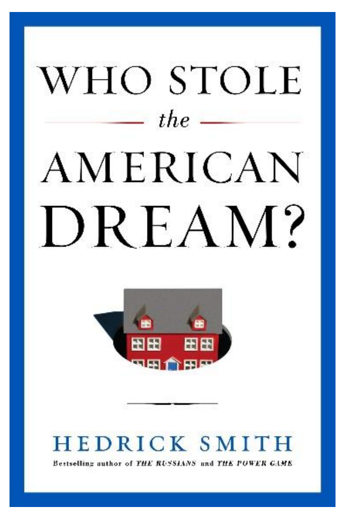
I agree that taxation should shift away from taxing labor. It doesn't make any sense that labor in the United States is taxed so heavily relative to capital. It will make even less sense in the coming years, as robots and other forms of automation come to perform more and more of the skills that human laborers do today.

But rather than move to a progressive tax on capital, as Piketty would like, I think we'd be best off with a progressive tax on consumption. Like Piketty, I'm also a big believer in the estate tax. Letting inheritors consume or allocate capital disproportionately simply based on the lottery of birth is not a smart or fair way to allocate resources.

The debate over wealth and inequality has generated a lot of partisan heat. Even with its flaws, Piketty's work contributes at least as much light as heat. And now I'm eager to see research that brings more light to this important topic."

Dear Reader, if it isn't clear, Piketty is considered to be politically liberal and his policy recommendation—use taxes to remedy the inequity—reflects this, however, his historic analysis is respected on both ends of the political spectrum. I want to get to the relevancy of the Fairshare Model on this issue while sampling a range of perspectives on the drivers of income inequality. Before moving to the views of conservative writers, I'll mention that in 2013, Hedrick Smith wrote a thoroughly researched book by about the drivers of income inequality in the U.S., *Who Stole the American Dream*. Here is the summary from *Booklist* the review journal of the American Library Association (bold added for emphasis).

Smith, Pulitzer Prize–winning reporter, explains how the middle-class prosperity after WWII was reversed [after] the 1980s because of a long period of sweeping transformations both in Washington's policies and in the mind-set and practices of American business leaders.



American corporations paid high wages and good benefits after the war; millions of workers spent their money; and business investment increased, which led to growth, expansion, and higher living standards. The 1980s ushered in the era of job losses and a lid on average pay scales; hence, consumer spending declined, and the nation's economy was negatively affected.

We learn the top 1 percent (3 million people) got two-thirds of the U.S. economic gain between 2002–7, and the 99 percent (310 million) got one-third. *Smith concludes, we are at a defining moment for America.*

Conservative Perspectives on Income Inequality

This succinct summation of the conservative view on income inequality was made by liberal journalist Timothy Noah the *New Republic* in November 2013.[88]

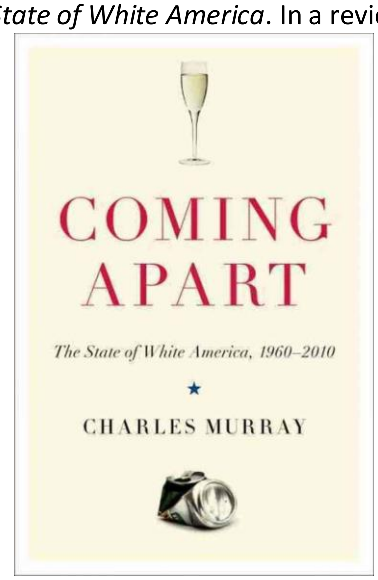
> *The usual conservative approach to income inequality (besides simply ignoring it) is to try to argue that it doesn't really exist, or to argue that if it does exist, it's mooted by upward mobility, or to argue that it's good for you.*

Noah seems to be repurpose conservative talking points about climate change. Nonetheless, conservatives may find his summation suspect, since he's not one of them.

Mathew Continetti, however, a journalist with established conservative bona fides. In a Nov. 14, 2011 article *Weekly Standard* called "About Inequality", he concedes that the inequality trend is probably real, and that it's a nasty business. He just doesn't think it's the government's place to do anything about it. Here's what Continetti had to say:[89]

> *The way out is to reject the assumption that government's purpose is to redress inequalities of income. Inequalities of condition are a fact of life.*
>
> *Some people will always be poorer than others. So too, human altruism will always seek to alleviate the suffering of the destitute.*
>
> *There is a place for reasonable and prudent actions to improve well-being. But that does not mean the entire structure of our polity should be designed to achieve an egalitarian ideal.*
>
> *Such a goal is fantastic, utopian even, and one would think that the trillions of dollars the United States has spent in vain over the last 50 years to promote 'equality as a fact and equality as a result' would give the egalitarians pause.*

Another conservative thinker, Charles Murray of the American Enterprise Institute, expressed a somewhat different perspective in his 2012 book, *Coming Apart: The State of White America*. In a review of the book called "A Conservative Take on America's Economic Divide", Niall Ferguson wrote:[90]



> *Murray is no apologist for Wall Street.*
>
> *Looking at the explosion in the value of the total compensation received by the chief executives of large corporations, he pointedly asks if "the boards of directors of corporate America—and nonprofit America, and foundation America—[have] become cozy extended families, scratching each others' backs, happily going along with a market that has become lucrative for all of them, taking advantage of their privileged positions—rigging the game, but within the law."*

[88] http://www.newrepublic.com/blog/timothy-noah/97448/honest-conservative-take-income-inequality
[89] http://www.weeklystandard.com/articles/about-inequality_607779.html
[90] http://www.newsweek.com/niall-ferguson-conservative-take-americas-economic-divide-64165

In his January 2012 review of Charles Murray's book, *New York Times* columnist David Brooks, another conservative writer, wrote:[91]

> *I'll be shocked if there's another book this year as important as Charles Murray's "Coming Apart." I'll be shocked if there's another book that so compellingly describes the most important trends in American society. Murray's basic argument is not new, that America is dividing into a two-caste society. What's impressive is the incredible data he produces to illustrate that trend and deepen our understanding of it.*
>
> *His story starts in 1963. There was a gap between rich and poor then, but it wasn't that big. A house in an upper-crust suburb cost only twice as much as the average new American home. The tippy-top luxury car, the Cadillac Eldorado Biarritz, cost about $47,000 in 2010 dollars. That's pricey, but nowhere near the price of the top luxury cars today.*
>
> *More important, the income gaps did not lead to big behavior gaps. Roughly 98 percent of men between the ages of 30 and 49 were in the labor force, upper class and lower class alike. Only about 3 percent of white kids were born outside of marriage. The rates were similar, upper class and lower class. Since then, America has polarized. The word "class" doesn't even capture the divide Murray describes. You might say the country has bifurcated into different social tribes, with a tenuous common culture linking them.*
>
> *The upper tribe is now segregated from the lower tribe.* T*oday, Murray demonstrates, there is an archipelago of affluent enclaves clustered around the coastal cities, Chicago, Dallas and so on. If you're born into one of them, you will probably go to college with people from one of the enclaves; you'll marry someone from one of the enclaves; you'll go off and live in one of the enclaves.*
>
> ***Worse, there are vast behavioral gaps between the educated upper tribe (20 percent of the country) and the lower tribe (30 percent of the country). This is where Murray is at his best, and he's mostly using data on white Americans, so the effects of race and other complicating factors don't come into play.***
>
> *Roughly 7 percent of the white kids in the upper tribe are born out of wedlock, compared with roughly 45 percent of the kids in the lower tribe. In the upper tribe, nearly every man aged 30 to 49 is in the labor force. In the lower tribe, men in their prime working ages have been steadily dropping out of the labor force, in good times and bad. People in the lower tribe are much less likely to get married, less likely to go to church, less likely to be active in their communities, more likely to watch TV excessively, more likely to be obese.*
>
> *Murray recommends that the upper tribe be more outspokenly judgmental about non-productive behaviors of the lower tribe, and, that they reduce their self-imposed geographic isolation of living in wealthy enclaves or "Super Zips" (the 900 or so zip codes of affluent communities).*

Fast forward two years. A stubbornly slow economic recovery, building resentment over the bank bailouts early in the Great Recession, Occupy Wall Street protests and numerous other indicators of

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[91] "The Great Divorce", by David Brooks, Jan. 30, 2012, New York Times, http://nyti.ms/127CFJT

widespread anxiety about the future and dissatisfaction about the-way-things-are-done have come to the forefront of public discussion. Consider this excerpt from David Brook's 2014 column, "The Inequality Problem".[92]

> *Suddenly the whole world is talking about income inequality. But, as this debate goes on, it is beginning to look as though the thing is being misconceived. The income inequality debate is confusing matters more than clarifying them, and it is leading us off in unhelpful directions.*
>
> *In the first place, to frame the issue as income inequality is to lump together different issues that are not especially related.*
>
> *Second, it leads to ineffective policy responses.*
>
> *Third, the income inequality frame contributes to our tendency to simplify complex cultural, social, behavioral and economic problems into strictly economic problems.*
>
> *Fourth, the income inequality frame needlessly polarizes the debate.*

There seems be little argument that income inequality has been growing and that it presents a threat to the well-being of society in America and elsewhere. On *Fox News*, whose audience is reliably conservative, media pundit Howard Kurtz said the following in January 2015:[93]

> *Suddenly leading Republicans are openly embracing the notion that income inequality is a clear and present danger that must be addressed. That is such a tectonic shift that it moves the national debate several degrees to the left.*
>
> *It's not that congressional Republicans are going to pass sweeping legislation to boost the income of the lower and middle classes. But it tells you something about how they read the mood of the country. What agile politicians do is try to coopt issues that the other side views as strengths. Real change is often preceded by an evolution in the way politicians frame an issue.*
>
> *In the past, when Democrats pounded away at the gap between rich and poor, many Republicans accused them of class warfare. Obviously, the GOP would explore a different mix of incentives and reject pitches to tax the rich and Wall Street to finance lower levies for the middle class. But after being pilloried as the party of the 1 percent, several of its biggest names are now saying the 1 percent have too much of the pie.*

The question is, what initiatives to reduce income inequality will Republicans support? After all, they now control the legislative branch.

[92] "The Inequality Problem", by David Brooks, Jan. 16, 2014, New York Times, http://nyti.ms/19y4XIh
[93] "The GOP's 2016 playbook? Republicans rip income inequality" http://www.foxnews.com/politics/2015/01/22/gop-2016-playbook-republicans-rip-income-inequality/

Another Take: R > L

Like many, I've contemplated the relationship between the distribution of wealth/income and social/political stability. Piketty provides scholarly evidence that income inequality is increasing and insight as to why.

Coincidently, before Piketty's book came out, I had formulated an explanation for income inequality and a formula that is remarkably similar to his. I think it has been increasing because the return on capital exceeds the "return on labor." This concept formula expresses the idea:

Return on Capital > Return on Labor

expressed as

R > L

My R is the same as Piketty's. My "L" is the "Return on Labor", which is a bit different from Piketty's G. To measure it, one might take real wages (i.e., inflation-adjusted) and add proxies for a sense of security, belonging, and purpose.[94] These senses are a bit nebulous, but so too are "consumer confidence" and "investor sentiment," both of which are regularly commented on. The Return on Labor is this sort of measure; a somewhat quantifiable, but largely sensed, read of the broad population's sense of economic vitality and optimism. Ultimately, I see L as a barometer of social stability.

Utilizing "economic impressionism" (i.e., relying more on observation and contemplation than on data), I surmised that the Return on Labor has been in decline, relative to the Return on Capital. And, the phenomenon gained traction in the 1980s due to significant expansion in the population available to perform labor-intensive work.

On an after-tax basis, relative to the Return on Capital, the Return on Labor has declined even faster than on a before-tax basis. Taxes on capital gains (15% or less) have fallen over the years while taxes on labor have increased.

The adoption of export oriented policies by China, India and other countries ushered in a new age for labor-intensive products and services on markets worldwide.

In 1991, the Soviet Union dissolved. Russia, along with China, puzzled on how to transition from a centrally controlled economy to one that was more market oriented, while minimizing political instability.[95] President George H. W. Bush proclaimed "A New World Order" was emerging. He was conveying optimism about the future. But the battle for the commanding heights of the world economies merely shifted from one based on political ideology to one driven by market economies.[96]

[94] I had this notion before learning about the Good Life that Edmund Phelps describes.

[95] A fundamental question was whether to redistribute state-owned property (everything was state-owned), then deregulate prices? Or, deregulate prices and then redistribute property? Russia opted for the former. China chose the latter approach, but controlled price increases in order to minimize social disruption.

[96] An insightful examination of how the 20th Century progressed to globalization is provided by Daniel Yergin and Joseph Stansilaw in their 2002 book "The Commanding Heights: The Battle for the World Economy" A PBS program based on the book can be streamed here http://www.pbs.org/wgbh/commandingheights/hi/story/index.html

The formation of the European Union in 1992 had a similar effect in Europe because products made in member countries that had low labor cost could enter those with high labor cost without restriction or taxes. In the U.S., trade agreements with Canada, Mexico and other countries added to the effect. "Globalization" was coined to describe what was going on, increasing integration of economies around the world.

These changes created a new world order for the Return on Labor, for increasingly, labor was becoming a commodity. Labor intensive industries like textiles and furniture were among the first to be affected but capital intensive industries like tires and steel followed because reducing the variable cost of labor positioned them to cover their fixed costs faster.[97] Few markets were unaffected.

Computer and telecom technologies extended the impact to all manner of service sector jobs. Not only were there off-shore call centers to handle customer support, there were radiologists in distant lands who competed to evaluate the x-ray image taken at the local hospital.

The Return on Labor diminished not just because of competition from people in distant lands. It happened as technologies spawned more efficient ways to perform work. Industries characterized by concentration of economic power increasing saw challenges by upstarts. The rise of portable, networked computers reduced the demand for office secretaries that typed and organized correspondence. Farmers, manufacturers and service providers adopted technologies that made them more effective; in part, by using labor more efficiently.

In the 1990s, I was struck by a story about U.S. gravestone cutters in Georgia who faced competition from China. If workers who support local cemeteries could displaced low cost workers other side of the globe, I thought that few markets would be untouched by globalization.

New business models deteriorated the Return on Labor too. Sometimes, regulatory reform led to new business models. Often, they arose from new technologies, but they always were driven by innovative thinking. For example, Big Box retailers emerged who displaced local merchants by combining their access to products made in low-cost markets, sophisticated supply-chain technology and new business strategies. Travel, newspapers, and book publishing and distribution were similarly transformed.

The bottom line is that very few markets avoided movement toward making labor a commodity.

Consumers were winners, however—they got lower prices.

So too were companies that reduced their cost of labor (i.e., wages, benefits).

Investors who made good bets on innovators saw the value of their investment climb; those who hung onto shares in non-innovative firms saw losses.[98]

The losers were workers and suppliers who were not competitive. Those who remained competitive had higher insecurity because their world could change quickly.

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[97] Governments in these emerging exporters also had weak environmental laws, subsidized business operations and managed currency exchange rates to provide a cost advantages.

[98] "Buy and hold stock for the long term" increasingly sounded like quant advice.

Common Ground?

Liberals and conservatives agree that income inequality is real and a problem. That suggests that policy makers will agree on some steps to address it. Tax policy is the obvious tool, but it's also a contentious one and vulnerable to being defined by self-serving political interests.

With the Fairshare Model, I propose an additional path to explore, one that should appeal to those whose politics are on the left, center and right. I dub it the "Paul McCartney Solution" because his song "Let Em' In" captures the idea—**expand the opportunities for workers to earn the return on capital.** Besides, everyone likes Sir Paul.

Let 'Em In chorus

Someone's knockin' at the door
Somebody's ringin' the bell
Someone's knockin' at the door
Somebody's ringin' the bell
Do me a favor, open the door and let 'em in

By Paul McCartney

The Fairshare Model helps workers get in on the higher return on capital in two ways:

1. It helps small investors to invest in venture stage companies at lower valuations. They don't have many attractive opportunities to earn a return on their capital; they rely on the return on their labor. A lower valuation reduces the cost of a position (e.g. a hundred shares will cost less). This, in turn, increases the return of a good investment and reduces the cost of a losing one. It also makes it easier to diversify a venture-stage portfolio and increased diversification reduces portfolio risk.

2. Employees "capitalize" the value of their collective performance when Performance Stock converts. Without having to risk capital, they can earn a capital gain as a result of their labor.

The ability of the Fairshare Model to ameliorate income inequality will take generations to test because the outcome of companies that adopt the model will take years to play out. Not only that, it will only pay off for those who invest in or work for a successful venture. Therefore, it is not a general panacea.

Still, it's something to contemplate. Policy makers chart a course to where they want the economy and society to be in a few decades. To the extent the Fairshare Model is part of that vision, it's a vote for an entrepreneurial economy that offers opportunity for the 99%. Meanwhile, the model has clear potential to benefit the capital-starved start-up sector, which has a clear record of spawning economic growth and job creation.

Reflect how much money might be channeled to these two groups of workers—small investors and employees in the companies that they invest in. If the Fairshare Model is used by public companies that trade on large exchanges; the capital gains earned by employees could rival the return that hedge funds deliver to their investors…billions of dollars! Some of these funds profit from trading ahead of average investors, sometimes on inside information. In the Fairshare Model, when favorable developments result in Performance Stock conversions, some of the upside that a fund would normally reap will be redirected to employees.

Is the Fairshare Model Capitalism?

Some have told me that the Fairshare Model smacks of communism or socialism. I find this odd. The most basic reason is that those models share wealth at the macro-economic level while the Fairshare Model shares it at the micro-economic level, between those who provide capital and those who provide the labor that make the capital worth more. Put simply, if not puckishly:

> Karl Marx said "From each according to his abilities, to each according to his needs."
>
> Karl Sjogren says "Fairly share the rewards of backing a venture-stage company between those who provide capital and those who make it worth more by virtue of their labor."

The Fairshare Model is not designed to address income inequality. It is designed to give public investors a deal that is comparable to what a VC would get. Doing so improves the opportunity for a return on capital for IPO investors that based on supporting the company, not getting in front on a Wall Street orchestrated "pop." It also creates an opportunity for employees to earn the return on capital for their labor.

Enabling employees to earn the return on capital for their labor (via Performance Stock conversions) is effectively a Rorschach test that reveals ones deep sensibilities about the relationship between capital and labor.

A favorable response to the Fairshare Model will come from people who support ways to make capitalism work better for more people. They will see micro-economic benefits to companies, investors and workers from a better alignment between investors and employees. They will see macro-economic benefits for a nation too. In part, because of the amount of money that could be redirected from secondary market traders to workers, once the Fairshare Model becomes the New Normal. They will also see a psychological benefit in that the model will inspire a venturesome spirit—boost an economy's sense of vitalism, described in the last chapter. Put another way, it will feed a society's "animal spirits", the term coined by economist John Maynard Keynes to describe the confidence, the emotional mindset, to invest or spend.

The Fairshare Model will evoke a skeptical, and possibly hostile, response from some people. They will include traditionalists and those who think that the human behavior challenges (i.e., the ability to cooperate) that must be addressed will be not worth the effort. A negative reaction may come from those who aspire to profit from the-way-things-are-now because the Fairshare Model goes into the belly of the beast, into the DNA of capitalism—valuation—and presents a radically different vision for how way to address it. Of course, there are such folks who will favor a fairer variant of capitalism. Finally, there will be those who see bets on valuation as the essence capitalism; they will have trouble with an effort to loosen the risk of setting a valuation from the risk of delivering performance.[99]

I look forward to engaging skeptics, because their questions will focus attention on matters that are better to confront before the Fairshare Model has its initial tests. To traditionalists, I simply say that the Fairshare Model strengthens virtuous aspects of capitalism by encouraging the allocation of reward based on merit and it does so by summoning stronger market forces.

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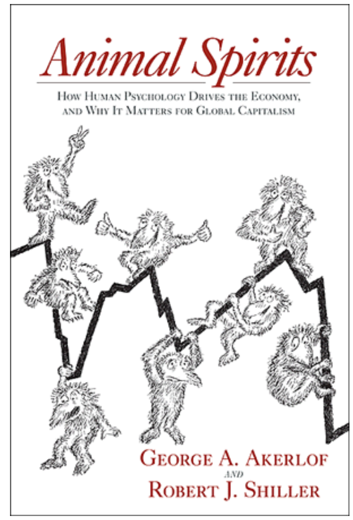
[99] These types are likely to enjoy a sporting event more if they know the betting spread set by odds makers.

Incidentally, John Maynard Keynes and Edmund Phelps are not the only economists to focus on the "animal spirits" an economy. In 2009, George A. Akerlof[100] and Robert J. Shiller, each of whom is a winner of the Nobel Prize, published *Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism*. The newspaper *The Economist* describes some of the book's take-away points as follows:[101]



- Conventional economic analysis confines itself to rational, quantifiable facts. However, economic decision makers are often intuitive, emotional and irrational.

- Confidence or lack of it can drive or hamper economic growth.

- Fairness matters greatly in setting wages, but classical economic models ignore it.

- People tend to reach irrational conclusions about money; this is the "money illusion." For example, they ignore inflation and believe their savings maintain their value; or they resist pay cuts when prices fall – even if their jobs may be at stake.

- Stories of corruption and broken trust can contribute to economic depressions.

- Minorities have a different story of America than whites do. Their story depicts an unfair society offering less opportunity than the majority perceives.

- Economists and policymakers need to shed the untenable theory of rational, efficient, self-correcting markets and pay appropriate attention to animal spirits.

[100] Akerlof is married to Janet Yellen, who is chairman of the U.S. Federal Reserve Bank.
[101] https://www.economist.com/media/pdf/animal-spirits-akerloff-e.pdf

Economic Justice in the New Issue (IPO) Market

The Fairshare Model offers an approach to the income inequality problem for a narrow communities of interest. It is not a solution for a nation. Some readers will appreciate the comparison to a city-state versus a nation. Before the formation of nation-states, humans organized their affairs in autonomous city-states. Today, Vatican City and Monaco are city-states and Hong Kong has historically been one. The states or provinces that now comprise nations reflect a city-state origin.

The community of interest I have in mind is not defined by geography. It is comprised of people buy the IPO stock of a venture-stage company, and, people who work for such a company. It will be easier to find broad support for steps that address income inequality for this narrow group than for an entire nation. Such a focused approach may appall some who want to see a comprehensive solution, but, it is in keeping with the fractured nature of society today and reflects political realism.

The Fairshare Model is not a cure for broad income inequality but it is a solution for a micro-economic problem for investors and entrepreneurs—how to value a venture-stage company when it sells its stock to the public. The model straddles two communities of interest in an issuer's sphere. Those who provide it with capital and those who provide it with labor. It frames a relationship whereby each can benefit from the other. The providers of capital get a low valuation. Those who provide labor get the capital they need to build a company and an upside if they perform. The contribution to reducing income inequality is that many people who will have interest in the IPO shares of a company that adopts the Fairshare Model will be unaccredited investors, as will be most of those who work for the company. Indirect benefits will flow to the communities where such companies are located. And, as the company performs, it generates opportunity for others. Essentially, the model promotes mass flourishing and more competitive capitalism (versus corporatism or crony capitalism). There is a lot to like, regardless of where one is on the political spectrum.

In Mass Flourishing, Edmund Phelps writes about the late John Rawls, former colleague of his, and his writings on economic justice. He offers this quote from Rawls' 1971 work, *A Theory of Justice* that:[102]

> *A society is a cooperative venture for mutual advantage….There is an identity of interests, since social cooperation makes possible a better life for all than any would have if each were to live solely by his own efforts. There is a conflict of interests, since persons are not indifferent as to how the greater benefits produced by their collaboration are distributed, for in order to pursue their ends they each prefer a larger to a lesser share. A set of principles is required for choosing among the various social arrangements which determine this division of advantages and for underwriting an agreement on the proper distributive shares. These…are the principles of social justice.*

Phelps then writes "The classic defenders of capitalism…have sought an economy having few "interferences" with what they see to be the good in capitalism—the 'freedoms' and the 'growth'—without a thought for what a just economy is. In the premise of some of these classic defenders, each participant receives in pay the value of his or her contribution to the national product, exactly as if each

[102] *Mass Flourishing*, pages 289

worked in isolation, so it is difficult if not impossible to see what moral claim one sort of participant might have to the pay of other sorts. But this premise is untenable." [103]

He adds that other defenders of capitalism "while conceding that the low earners benefit the high earners, jump in to say that the high earners, through their capital investment and innovation, greatly benefit the low earners—puling up their wages and employment. They see no reason why the high earners should dig into their pockets to pay subsidies aimed at further benefiting the low earners. But this view of a market economy is as mistaken as the previous one. The free market sets wages that send signals and present incentives serving *efficiency*—in some rough and ready way, at any rate—*not* any ideas of *equity*."[104]

The preceding comments were about after-tax wages in an economy. How might these ideas on economic justice apply to the IPO market? Phelps doesn't focus on that, but he sets up that question when he notes that "A modern economy is striking for the *extraordinary income*—oversize profits and capital gains in anticipation of profits—that accrues to those whose new idea or whose entrepreneurial development or marketing of a new idea led to a successful adoption in the marketplace."[105] He seems to be describing the high—outsized, in many cases—valuations associated with venture-stage companies that represent *wealth delivered today in anticipation of future performance*.

As discussed in chapter three, The Problem With a Conventional Capital Structure, the capital formation process that begins with a VC investment and ends with a Wall Street IPO is constructed in a manner that has considerable disadvantage for public investors…and can disadvantage the angel investors who come in before a VC. Advantage in this allocation of wealth is based on efficiency—and market power—not based on any ideas of equity or economic justice.

Put another way, for a given company, if you are a VC, your dollar buys you more than an angel investor's dollar does, because you get better terms. And, if you are privileged enough to get an allocation of shares in a Wall Street IPO, your dollar gets a better deal than the average investor waiting to buy shares in the secondary market. That is, the deal you get is based on who you are more than the company's performance.

Rawls identified two principles that would lead to a just and moral society. The first is that each person have liberty that is compatible with the liberty of others. The second is that social and economic positions be designed to everyone's advantage and open to all. In other words, Rawls said economic justice improves when open opportunity expands and corporatism—rules and practices that privilege certain players—is reduced. He conducted experiments in which study subjects were told they would play a social-economic game after they defined the rules. When participants knew in advance what their position in the game would be, they advocated rules that benefited someone in that position. When they did not know what position they would occupy, they designed rules that did not favor any type of player over another. Rawls allowed that a justly functioning system could have unjust outcomes—he found that participants based their assessment of the fairness of the system based on whether it appeared to be a justly functioning, not on the outcome.

[103] *Mass Flourishing*, pages 289
[104] Ibid, pages 290
[105] Ibid, page 293

Now, with all this in mind, reflect on the thought experiment about Wall Street IPO allocations that was at the end of chapter three.

> **Thought Experiment**
>
> Imagine that, starting tomorrow, shares in Wall Street IPOs are allocated by lottery, not by wealth, privilege or connections.
>
> Will investors who have routinely been able to get shares at the IPO price thus far be content with a conventional capital structure?
>
> If, starting tomorrow, they have to buy shares in the secondary market (from those who win the lottery), might these well-connected investors clamor for a different approach to valuation?

The Fairshare Model focuses on valuation; making it more fair, more driven by actual performance than by speculation about fleeting Next Guy economics. Imagine that those who now occupy a preferred position in the current capital formation process had to redesign it in a Rawlsian thought experiment. The study participants would include entrepreneurs, angel investors, VCs, underwriters and their favored customers for IPO allocations and average investors. No person designing the process would know in advance what position they would occupy in the game. So, someone who was actually a VC or entrepreneur, might be a public or angel investor in the game. Or, an underwriter might be an entrepreneur or public investor.

I think that the rules for valuation and share allocation that would emerge from such an experiment would resemble the Fairshare Model, don't you?

When a well-performing company adopts the Fairshare Model, there are more winners. But who loses? The largest group, I suspect, will be traders in the secondary market. Those who "buy on the rumor and sell on the news", or, buy on talk of performance and sell when it is announced. They lose in the Fairshare Model because a significant portion of the increase in the market capitalization that results from actual performance goes to those who delivered the performance…the company's employees.

Arguably, this is consistent with a justly functioning—and well functioning—system because while speculators provide something useful, liquidity, they don't invent or make anything and they don't provide the capital to those that do.

Onward

The next chapter will consider how the dynamics of the Fairshare Model promotes a new vector of economic competition…the ability to cooperate.

Chapter 10: Cooperation as the New Tool for Competition

Preview

- Foreword
- Big Solutions to Big Problems are hard to find
- Cooperation as a model for competition
- The size of the prize (or the economic pie)
- The power of cooperation as a model for competition
- Cooperation in animals
- What Does Adam Smith Say About Human Nature?Diversity in Common Purpose
- Common Purpose is what you make it
- Isn't "Maximization of Shareholder Value" the Common Purpose?
- Diversity in Common Purpose
- A Common Purpose Panorama
- Onward

Foreword

John Donne was an English poet, satirist, lawyer and priest who died in 1631. He wrote this piece[106], which has always touched me:

> *No man is an island, entire of itself; every man is a piece of the continent, a part of the main. If a clod be washed away by the sea, Europe is the less, as well as if a promontory were, as well as if a manor of thy friend's or of thine own were: any man's death diminishes me, because I am involved in mankind, and therefore never send to know for whom the bells tolls; it tolls for thee.*

Those who benefit from the return on capital have a stake in addressing the social anxiety about the diminished return on labor. Few would challenge that, yet there is little agreement on what to do about it.

Higher taxes on income, capital gains, and inherited wealth are favored by the left. Reducing regulation and promoting business interests in the hope of growing the pie are favored by the right. Tax code simplification and improved worker training has supporters on both sides. Shifting the tax focus from income to consumption will be subject to debate. For some, the allure of trade agreements is dubious, but that die is pretty much cast—nations see net positive results for enhancing the integration of economies.

No matter what emerges from the policy making process, it is apparent that the supply of labor will continue to grow, as will the use of robotics. The result will be continued pressure on the return on labor, relative to the return on capital.

[106] Meditation XVII, by John Donne

By now, you recognize that the Fairshare Model relies on cooperation between the Investor and Performance Stock classes. Some will view this as a weakness. In this chapter, I'll argue that the ability of capital and labor to cooperate could be a competitive strength that helps companies outperform rivals, be they business competitors or rivals for desirable employees.

As you go through it, I'd like you to contemplate how this ability, when combined with efficient and transparent capital markets, offers five important macro-economic benefits to a society:

1. Better matching capital with opportunity should generate economic growth and job creation (see chapter eight);

2. Encouragement of an economy's indigenous ability to innovate (see chapter eight);

3. Expand the ranks of those who participate in the return on capital (see chapter nine);

4. Broader pursuit of an Aristotelian *Good Life*, the concept that Edmund Phelps discusses in *Mass Flourishing,* will be encouraged (see chapter eight); and

5. Promote Wall Street IPOs that are less gamed (see chapter four) and more in line with John Rawls' *Theory of Economic Justice* (see chapter nine).

As you prepare to flip the page, I hope you appreciate that the Fairshare Model is a Big Idea, but it is not a Big Solution to the macro-economic problems of capitalism.

Rather, it is a market-driven micro-economic idea that is focused on the interests of a very small group—public investors in a venture-stage company's IPO. Of secondary importance are the interests of entrepreneurs and their pre-IPO investors.

Collectively, we're not talking about a lot of people. A few thousand per year while the model is in the early adopter phase. A few hundred thousand annually once it enters the mainstream market, but significantly more as the model grows in acceptance. That's how ideas lead to change in societies—gradually.

The Fairshare Model is not a utopian idea—it is intended to be a practical idea to foment innovation and growth in the economy, and directly help capitalism work better for a few more people and, indirectly, for a larger number.

Big Solutions to Big Problems are hard to find

Philosophers have long puzzled, "What system most benefits a society?" The question lurks as gripes about how capitalism is practiced increase. The discussions focus on how things end-up, whether it's wealth concentration, wage levels, environmental issues or other concerns. These are Big Problems.

For some, the solution for a Big Problem is a Big Solution; something revolutionary. The U.S. Marshall Plan for Europe and the social security system were Big Solutions to Big Problems. The problem with a Big Solution is that they can appear Too Big to gain broad support. And, all indications are that it will be difficult to find broad support for Big Solutions to the problems of weak economic growth and rising income inequality.

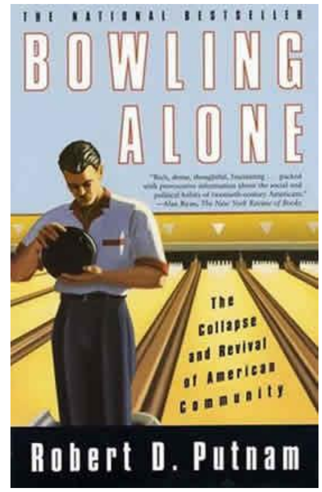
Of course, objections to Big Solutions tend to melt in the face of a common threat because it promotes common cause. In America, the creation of securities laws followed the Wall Street Crash of 1929. The Patriot Act ushered in transformative changes in banking and travel after the 9/11 terrorist attacks. The Sarbanes-Oxley Act strengthened financial reporting controls after a series of scandals at large firms. Concern about how the benefits of capitalism are distributed is mounting in the streets and in the suites of executives and policy makers, but it hasn't jelled to "a common threat for which there is a shared response." As a result, the potential for solutions inspired by common threat is unclear.

Common values foster common cause, but not always effective action. Some societies that share values—Germany, Sweden and Canada come to mind—seem less likely to need a Big Solution because they address problems before they become a Big Problem. Other societies can be crippled by shared values. The desire to avoid disharmony helps explain the difficulty that Spain, Greece and Japan have responding effectively with their economic problems.

For a variety of reasons, it's increasingly difficult to find common cause. It's ironic, because each of us can reach more people, more rapidly, with more information than ever before. Miguel de Cervantes' fictional character *Don Quixote* undertook a quest to change the world and right all wrongs while practicing respect and promoting civility toward others. Quixote would surely despair at the current state of social dialog, captured by one humorous observer who suggests that the most frequent sentence used over the Internet is "You're an Idiot!" with the second being "It's a Hoax!"[107]

[107] "I've Discovered the Internet's Most Internet Sentence, and Your [sic] an Idiot if You Disagree" by Matthew Malady, New Republic, http://www.newrepublic.com/article/116769/your-idiot-internets-most-internet-sentence

Sociologist Robert Putnam examines this phenomenon in his 2001 book, *Bowling Alone: The Collapse and Revival of American Community*. He notes that civil society is breaking down as Americans become more disconnected from their families, neighbors, communities, and the republic itself. Organizations that gave life to democracy are fraying. He adopts bowling as a metaphor, observing thousands of people once belonged to bowling leagues but nowadays, they're more likely to bowl alone. He writes that:[108]



> *Television, two-career families, suburban sprawl, generational changes in values--these and other changes in American society have meant that fewer and fewer of us find that the League of Women Voters, or the United Way, or the Shriners, or the monthly bridge club, or even a Sunday picnic with friends fits the way we have come to live. Our growing social-capital deficit threatens educational performance, safe neighborhoods, equitable tax collection, democratic responsiveness, everyday honesty, and even our health and happiness.*

So, there is little prospect of a Big Solution to the problems of economic growth and income inequality. That's because there is insufficient support for something revolutionary, no commonly perceived threat and it is difficult to find common cause based on philosophy, values or beliefs in what capitalism should deliver, even though it is generally viewed to be the best system.

The "best system" question is ancient, by the way. Around 380 B.C., in a dialogue known as *The Republic,* the Greek philosopher Plato presented a utopian idea, one where citizens who completed fifty years of rigorous training would be "philosopher-kings" with the wisdom to fairly distribute resources so there was no poverty. The Republic "has few laws, no lawyers and rarely sends its citizens to war, but hires mercenaries from among its war-prone neighbors (these mercenaries were deliberately sent into dangerous situations in the hope that the more warlike populations of all surrounding countries will be weeded out, leaving peaceful peoples)."[109]

Wikipedia notes that the word "utopia" was coined about two thousand years later by Sir Thomas More for his 1516 book *Utopia*, which described a fictional island society in the Atlantic Ocean. Then it adds:

> *The word comes from the Greek: οὐ ("not") and τόπος ("place") and means "no-place". The English homophone eutopia, derived from the Greek εὖ ("good" or "well") and τόπος ("place"), means "good place".*

Homophones are words that sound the same but are spelled differently and have different meanings (e.g., assistance and assistants; sear and seer; fair and fare). Knowing that, you'll be amused by Wikipedia deliciously pointing out that:

> *"Because of the identical English pronunciation of "utopia" and "eutopia", it gives rise to a double meaning*"—for it sounds like both "no place" and a "good place.

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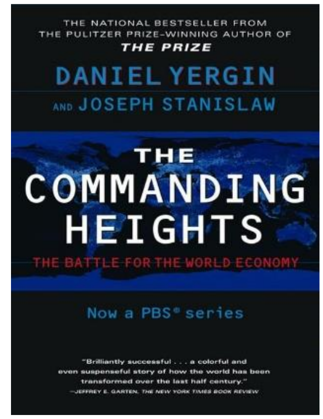
[108] Bowling Alone: The Collapse and Revival of American Community, by Robert Putnam, page 367
[109] http://en.wikipedia.org/wiki/Utopia

Utopia may be a mythic place, but the desire to find it can have great consequence. The most spectacular example in the 20th Century was the epic struggle over whether the world economies would be controlled by an idealized state or by imperfect markets. It was a battle over whether communism or capitalism would most benefit mankind. It began intellectually, with competing ideas about what was the "best system" for society, then manifested into physical and economic combat.

This struggle was the subject of the 1998 book, *The Commanding Heights: The Battle for the World Economy* by Daniel Yergin and Joseph Stanislaw, which was made into a three part PBS series by the same name in 2002. I cannot recommend this more highly to anyone with interest in the role that economics played in recent world history. Here is how the the first episode opens: [110]



> PROGRAM NARRATOR: This is the story of how the new global economy was born, a century-long battle as to which would control the commanding heights of the world's economies -- governments or markets; the story of intellectual combat over which economic system would truly benefit mankind; the story of epic political struggles to implant those ideas on the nations of the world.
>
> JEFFREY SACHS, Professor, Harvard University: Part of what happened is a capitalist revolution at the end of the 20th century. The market economy, the capitalist system, became the only model for the vast majority of the world.
>
> NARRATOR: This economic revolution has defined the wealth and fate of nations and will determine the future of the planet.
>
> DANIEL YERGIN, Author, *Commanding Heights*: This new world economy is being driven by technological change and by political change, but none of it would have happened without a revolution in ideas.

Ultimately, communism failed everywhere, no country could make it work remotely close to its ideal, let alone as an admirable, sustainable system. This is evidence that capitalism is a better system but it does not mean that it can't be improved. *Good Capitalism, Bad Capitalism,* a book mentioned in chapter eight, points out that there is variation in how it is practiced; the dynamics in the U.S. differ from what they are in Canada, Germany, Great Britain, Sweden, Japan, Australia and South Korea, for instance.

What will define the epic struggle of the 21st century? Imagine what answers might have been offered about the 20th century a hundred years ago, as WWI was unfolding. It is unlikely that many would have guessed correctly as there was no competing ideology to capitalism.

I imagine that the 21st century will be defined by competition for resources and spheres of influence, stoked by conflict regarding values, beliefs and attitudes—traditional versus modern. The toll that modern society wreaks on the planet may well be the epic struggle, and it may involve nuclear devastation, be it by accident, war or terrorism. But these are not conflicts about *economic systems*. If the question is focused on that, I imagine that the defining challenge of the 21st century will be "How can the benefits of capitalism best be shared?"

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[110] It may be viewed on the PBS website http://www.pbs.org/wgbh/commandingheights/hi/story/index.html

Cooperation as a model for competition

I posit that the ability to cooperate will emerge as an important form of competition in the 21st century. I mean cooperation within and between micro-networks, not the sort of broad-based societal cooperation that relies on an overly optimistic view of human nature.

Micro-networks exist within an enterprise, its supply chain and its customer base. Within an enterprise, they exist between classes of shareholders, shareholders, directors and top management, top management and other employees and amongst non-employees. These micro-networks are layered on, and interacting with, each other—like themes in a musical fugue. They are partnerships with shifting and overlapping interests that center on whether the company is doing well. Micro-networks in successful companies favor positive, self-renewing ways of interacting while companies that generate negative, discordant themes are prone to dysfunction and eventual failure.

How might the benefits of capitalism best be shared? To be broadly supported, an answer must appeal to people with diverse philosophical views and also be practical. Since micro-networks are narrow, self-selecting associations of people, it is easier to define an approach that meets their needs than society at large. In other words, rather than a Big Solution, I propose a mosaic of Small Solutions to the Big Problem facing contemporary capitalism writ large.

Micro-solutions suit our times. There is no global economic threat that motivates joint action.[111] Common ties are weaker and world-views increasingly fractured; there is more talk about succession than about coming together. Students of history know that long before most countries were nation-states, they functioned as city-states, provinces, states or tribal regions. Perhaps we're reverting to what's natural; humans favor a smaller definition of common interest over the one Donne advanced during the Enlightenment.

Although many bemoan that assessment, few will disagree with it. There are good-hearted souls who wish to change that. While they work on it, I'll just accept that it's simply the course that we're on. And, suggest that the ability to cooperate could be be a competitive tool for those who invest in or work for companies that adopt the Fairshare Model.

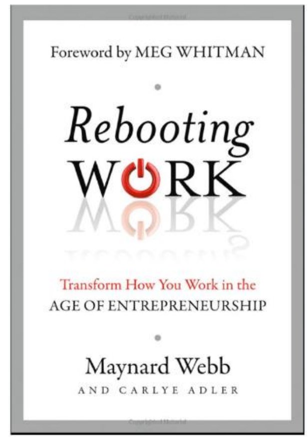
[111] Climate change is a broadly perceived threat but not one that yet motivates joint action.

The size of the prize (or the economic pie)

If cooperation is the means of competition, what is the competition for? What is the size of the prize or the economic pie? It has two components.

1. Economic growth that results from increasing productivity, and
2. Expanding the ability of working class people to participate in the increase in valuation that occurs in venture-stage companies.

The first component is straightforward. As discussed earlier, new companies are the engine of economic growth and job creation. In his 2013 book, *Rebooting Work*, Maynard Webb observes that:



> *The speed at which companies come and go, succeed and fail, is different from even a short while ago. The half-life of a company is diminishing incredibly quickly. One-third of the companies listed in the 1970 Fortune 500 were gone by 1983. (They were acquired, merged, or split apart.) The average life expectancy of a company in the S&P 500 has dropped from seventy-five years (in 1937) to fifteen years today.*[112]

Despite the shortened life-expectancy of companies, the U.S. economy has grown, fueled by new companies that offer ways to be more productive. Efforts to improve their ability to raise equity capital, therefore, can make a positive contribution to economic growth.

The size of the second component is large and hard to quantify, but is apparent when you think about it. It's the wealth earned by betting on the valuation of companies and it has two elements:

A. The increase in valuation that takes place when it is privately held, between its inception and when it is acquired or goes public,
B. The increase in valuation that occurs in the secondary trading market.

The collective amount of wealth that has been generated in recent decades by these two segments has been enormous and it has gone to a relatively small portion of society. The Fairshare Model has the potential to change this because it facilitates better investment opportunities for unaccredited investors. If public investors did fractionally as well in their investments as venture capitalists, it would be a better return than they can get otherwise (and involve more fun).[113]

Also, when Performance Stock converts to Investor Stock, a portion of the wealth created by an increase in the company's valuation goes to employees. At present, that portion goes to investors in the secondary market. Some of them trade based on better access to information than most investors. When a company uses the Fairshare Model, some of this wealth goes to the people whose work leads to the increase in valuation. That is, more wealth will go to those who create it and less will go to those who trade on information.

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[112] Rebooting Work; *Transform How You Work in the Age of Entrepreneurship*, by Maynard Webb and Carlye Adler, Jossey-Bass, page 52

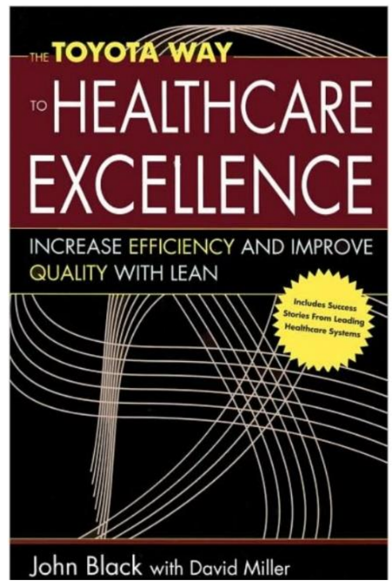
[113] Take another look at the charts in chapter two, the section called "A Bird's-Eye View of Possible Outcomes."

The power of cooperation as a model for competition

The ability of cooperation to be an effective competitive weapon was powerfully demonstrated by Toyota Motor Co. The so-called "lean manufacturing" concept that it pioneered is associated with concepts like zero defects and just-in-time inventory management. In such a system, micro-networks must collaborate, cooperate and communicate extensively. In contrast, variations of the "scientific management" philosophy favored by Toyota's larger competitors fostered an adversarial, command-and-control management style that emphasized time-study efficiency but fostered workplace alienation.

In his 2008 book, *The Toyota Way to Healthcare Excellence: Increase Efficiency and Improve Quality with Lean*, John Black writes:[114]

> *Sakichi Toyoda, who founded the Toyota Group, was the inventor of a loom that would stop automatically if any of the threads snapped. His invention reduced defects and raised yields, since a loom would not continue producing imperfect fabric and using up thread after a problem occurred. The new loom also enabled a single operator to handle dozens of looms, revolutionizing the textile industry.*



> *The principle of designing equipment to stop automatically and call attention to problems immediately is crucial to the Toyota Production System (the foundation of Lean Manufacturing). This is the system of "jidoka", the intelligent use of both people and technology, with the ability (even the obligation) to stop any process at the first sign of an abnormality.*

> *When the Toyota Group set up an automobile manufacturing operation in the 1930's (replacing the Toyoda family's "d" with a "t"), Sakichi's son, Kiichiro headed the new venture. He traveled to the U.S. to study Henry Ford's system in operation. He returned with a strong grasp of Ford's conveyor system and an even stronger desire to adapt that system to the small volumes of the Japanese market.*

> *Soon thereafter, the first Toyota system of manufacturing was born. To say that Toyota copied Ford is not accurate---Toyota learned from Ford, especially from Ford's mistakes. This demonstrated the power of the Toyota system: continuous improvement. It was in some ways a revolution, just as Ford's had been but the differences were often striking.*

I want to pause to point out that the scientific management approach to cost and quality has dramatically lost favor with manufacturers since the 1980s. Now, most of them—certainly many who are competitive with regard to cost and quality—have adopted variants of lean manufacturing or just "lean" when its principles are applied to non-manufacturing activities. As Black's book title indicates, that includes healthcare, which may surprise many; it affects design of operating rooms, nurse stations, management of supplies, accounting practices, etc.

[114] The Toyota Way to Healthcare Excellence: Increase Efficiency and Improve Quality with Lean, John Black with David Miller, page 28-29, Health Administration Press

The table below highlights how differently these two schools of management thought—the "old school" scientific management approach and the "new school" lean approach—address the Big Problems of how to build quality products and control costs.

<table>
<tr><th></th><th>Old School—Scientific Management</th><th>New School—Lean</th></tr>
<tr><td>Relies on</td><td>Command and control</td><td>Cooperation and communication</td></tr>
<tr><td>Viewpoint</td><td>Discrete or separate view of quality and cost—manage them to target levels.</td><td>Integrated view of quality and cost that relies on constant improvement</td></tr>
<tr><td>Approach to Product Quality</td><td>• Set acceptable defect rate.
• Find and fix defects.
• Fix the underlying problem if the savings will generate an acceptable return on the investment.</td><td rowspan="2">• Zero defect standard
• Internal process improvement
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• Extensive worker and vendor training
• Empower workers and vendors to improve process controls and reduce costs
• Incentives to improve quality and reduce cost</td></tr>
<tr><td>Approach to Product Cost</td><td>• Win price concessions from vendors and employees or replace them with lower cost equivalents.
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In the scientific management mindset, the Big Problem is the defect, not the process that created it. The solution was to inspect for quality and repair defects. A process improvement requires a cost/benefit justification.[115] Workers were replaceable cogs who were expected to keep the production line going, not to change a process. If they didn't keep up, they were fired. Vendors were pressured to reduce their price without collaboration as to how to do it.

In a lean system mindset, the Big Problem is a process that creates defects; a defect is a symptom of a Big Problem. Workers are empowered to stop a process if they see a defect. What follows is an intense search for the cause and a way to prevent it in the future. Suppliers are trusted partners who are transparent about their process—they collaborate with the manufacturer on ways to improve processes so costs come down and quality improves.

These two approaches differ in the importance of cooperation. They can also be contrasted by the type of relationships they promote, between employer and employee, and between a company and its suppliers. Scientific management tends to ignore the humanity of relationships while the lean approach acknowledges it.

My admiration for what Toyota accomplished is enhanced by my background. I grew up in the Detroit area, exposed to labor strife. My first job after college was at Ford Motor, performing cost/benefit analysis on transmissions while the scientific management approach was the standard and the Toyota Way was obscure. A few years later, in 1984, my then-spouse helped bring up the accounting department at New United Motor Manufacturing, Inc. (NUMMI) the Fremont, California joint venture between Toyota and General Motors that explored the portability of the Toyota system to the U.S.[116]

[115] My first job out of college was to analyze the cost/benefit of such solutions for a Big Three automaker.
[116] The NUMMI JV was liquidated in 2010 and its former facility is now the home of Tesla Motors.

After a stint in purchasing, where she worked with NUMMI suppliers, she then left to work for the United Auto Workers union. So, I had the opportunity to observe this unique enterprise from different perspectives, like a piece of art. One takeaway was appreciation for how many constituencies a business has—shareholders, lenders, employees, customers, suppliers and the community—and how well NUMMI balanced them. Another was those who advocate on behalf of a single interest have a less complex job than businesses.

Another, very different, experience informs my perspective on the power of cooperation. In the mid-‘80s, I worked for a Silicon Valley telecom manufacturer called Granger Associates. Just before I was hired, it had been acquired by a company with a centralized command and control style. Like virtually all companies, Granger Associates used an annual planning process, but its differed from what most used. It had been defined by a serial turnaround executive named Quentin Thomas Wiles (everyone referred to him as "Q.T.") who was also chairman of the San Francisco investment firm, Hambrecht & Quist. He was known as "Dr. Fix-It" as a result of a long and impressive record of revitalizing companies in a turnaround situation. In an article called "The Green Berets of Corporate Management", he was quoted as saying "I think I can fix anything."[117]

Q.T. left Granger when the transaction took place, so I never met him, but virtually every executive I worked with initially had worked for him. It was through them and from study that I came to understand his philosophy and methods for performance definition, measurement and reward. I learned that he applied a variation of the same structure in other turnarounds, and, that there were people who worked with him at more than one company.

Goal setting in Q.T.'s system was done quarterly. There was intense focus was on the next quarter, with slight attention to the remaining quarters in the year. There was no multi-year plan. Q.T. felt that a company makes it's year one quarter at a time, therefore, focus on the one in front of you. A key result of the planning process was to define the "5 Most Important Tasks" for each bonus-eligible manager. In Q.T.'s system, one's salary was about 80% of what the market rate was. If they earned their full quarterly bonus, their compensation could be 120% or more than market. So, the company had 20 opportunities a year (5 quarterly tasks times 4 quarters) to align interests in a tangible way with each manager. Each set of tasks reflected what a manager could affect—sales, production, inventory levels, product development targets, etc. The system, unsurprisingly, had a powerful effect on behavior. As quarter-end approached, those who had not yet accomplished their goals were highly focused on achieving them, if feasible. Higher level management monitored who was on track and who wasn't. They then took steps to try and make up the shortfall in one division with overachievement in another.

The theme of this chapter is cooperation. It existed at Granger—the *esprit de corps* was high. But the spirit of cooperation did not flow from an overly optimistic view of human nature. Rather, it flowed from well thought out understanding of a problem, goals to achieve, clear communication, accountability and the ability to influence outcomes. It was the spirit of cooperation that flowed from trust and confidence in oneself and in others. This was the result of Q.T.'s organizational philosophy.[118]

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[117] "The Green Berets of Corporate Management"

[118] Q.T. describes his organizational philosophy in this February 1988 interview with INC: "Company Doctor Q.T. Wiles," http://www.inc.com/magazine/19880201/7561.html

As a whole, Granger Associates made its quarterly targets. There was a vitality and dynamism in that organization that was the best I've ever seen. Compared to the annual plan approach favored by Granger's parent, indeed, by most U.S. companies, Q.T.'s approach unleashed the equivalent of what John Maynard Keynes might have have described as an organization's "animal spirits," a sense of purpose in the face of uncertainty. A significant reason was that managers had input on what their goals were and had the resources they needed to meet them.

After Granger Associates, one of Q.T.'s turnarounds, became his Waterloo. Miniscribe Corporation, based in Longmont, Colorado became infamous for fraudulent financial reporting. To meet targets, some managers at this publicly traded disk drive manufacturer falsified their performance, which came to light in an audit. Someone who knew Q.T., his system and people at Miniscribe told me that the system worked well when people shared an ethos that kept them from doing something wrong. He said that it failed at Miniscribe because some people did not understand where to draw the line.

These anecdotes illustrate facets of three important points about cooperation in the workplace. The first is that companies with cooperative micro-networks improve their odds of success. It only took Toyota a few decades to become the largest automaker in the world. The strength of its micro-networks was an important factor to its eventual triumph, for these networks helped make lean practices work. There is reason to believe that other companies, even start-ups, can achieve greater success with strong micro-networks of their own. In Silicon Valley, for example, the importance of a collaborative workforce and supply chain are well recognized.

The second point is that a reward system can evoke and direct cooperation. That's particularly true when the goals are specific and relevant, when the incentive goes deep into the organization and the reward for achievement is issued frequently enough to maintain the incentive.

The third point is that a good system can deliver a bad result. Q.T. Wiles' system had an impressive record: Miniscribe did not invalidate it. Other approaches to motivate employees have bad results too. Similarly, if a company applies the Fairshare Model ineffectively, this should not invalidate it. It's not a utopian solution but it's a promising one, if you subscribe to the idea that cooperative micro-networks have the potential to be a game-changer in the tough business of growing a business.

Few readers will question the advantages that accrue from a series of cooperative micro-networks. But some will feel this relies on an idealized notion of human society, and point out that its our nature to compete, to be selfish, to be sneaky or aggressive in order to advance one's interest. To the extent that that is true, that undercuts the notion that micro-networks of investors and employees can cooperate in a way that enables the Fairshare Model to function effectively.

Time and experience will test how well the Fairshare Model works. But, the next section will challenge the premise of this view of human nature. The idea that cooperation and fairness, indeed, empathy and compassion, qualities that John Donne expresses in the poem at the start of this chapter, are not natural human qualities.

Cooperation in animals

Some readers may accept the benefits of cooperation but be skeptical about the potential to achieve it.

"Humanity is actually much more cooperative and empathic than its given credit for" says Frans B. M. de Waal, a biologist known for his work on primate behavior. In 2007, Time named him one of The Worlds' 100 Most Influential People Today. In 2011, Discover had him among 47 (all time) Great Minds of Science. In November 2011, de Waal gave a TED talk—*Moral Behavior in Animals*[119]--on the capacity of primates to reconcile, share and cooperate. My edit of it for brevity and readability, is below.

I [Frans de Waal] discovered that chimpanzees are very power hungry and wrote a book about it. And at that time, the focus of animal research was on aggression and competition. I painted a whole picture of the animal kingdom, humanity included, that said deep down we are competitors, we are aggressive, and we're all out for our own profit basically.

But in the process of researching power, dominance and aggression, I discovered that chimpanzees reconcile after fights. And so what you see here [pointing to the screen] are two males who have had a fight. They ended up in a tree, and one of them holds out a hand to the other. And about a second after I took the picture, they came together in the fork of the tree and they kissed and embraced each other.

Now this is very interesting because at the time everything was about competition and aggression, and this didn't make sense. The only thing that matters is that you win or that you lose. But why would you reconcile after a fight? That doesn't make any sense.

The principle we found is that when you have a valuable relationship that is damaged by conflict, you need to do something about it. So my whole picture of the animal kingdom, including humans, started to change.

So we have this image in political science, economics, the humanities, and philosophy that man is like a wolf—deep down, our nature is nasty. I think it's a very unfair image for the wolf. The wolf is, after all, a very cooperative animal; that's why many have a dog, which has these characteristics also.

And it's unfair to humanity, because it is more cooperative and empathic than its given credit for. So I started getting interested in those issues and studying that in other animals.

If you ask, "What is morality based on?" two factors always come out.

- *One is reciprocity, and associated with it is a sense of justice and a sense of fairness.*
- *And the other one is empathy and compassion.*

Human morality is more than this, but if you would remove these two pillars, there would be not much remaining--they're absolutely essential.

(Video of two experiments are shown that demonstrate the point.)

[119] View Professor de Waal's TED talk here http://www.ted.com/talks/frans_de_waal_do_animals_have_morals

We also published an experiment where the question is, "Do chimpanzees care about the welfare of somebody else?" It's been assumed that only humans worry about the welfare of others. We found that the chimpanzees care about the well-being of others -- especially, members of their group.

The final experiment that I want to mention is about fairness. It has been performed in many ways. I'm going to show you the first experiment that we did with capuchin monkeys but has been done with dogs, birds and chimpanzees.

We put two monkeys in a test chamber side-by-side, so they see each other. These animals know each other. Each has a simple task to do to get a reward—hand us back a rock. The reward is a piece of cucumber. As you can see, they're perfectly willing to do this repeatedly. Cucumber is fine for them, but they prefer grapes. If you give one monkey cucumber and the other a grape, you create inequity between them. That's the fairness experiment.

In the videotape, the one on the left gets cucumber for returning the rock to the researcher.

(Monkey on the left gets rock from researcher, returns it and gets a cucumber reward)

The first cucumber is perfectly fine as a reward for the one on the left. The first piece she eats.

(Next, the monkey on the right hands gets from researcher, returns it and gets a grape reward.)

Then she sees the other one on the right get a grape for the same task. Watch what happens.

(Monkey on the left that got cucumber shows envy of the monkey on the right that got the grape)

The one on the left again gets the rock, gives it back, and gets a piece of cucumber.

(Audience howls when the monkey on the left throws the cucumber back at the researcher.)

(More laughter as the monkey extends her arm to reach for the out-of-reach grape dish. Frustrated and angry, she shakes her cage and slams her hand on the table to get the attention of the researcher.)

(Continued laughter when the sequence is repeated and the monkey on the left remains angry)

So this is basically the Wall Street protest that you see here. (Uproarious audience laughter)

Let me tell you a funny story about this. This study became famous and we got a lot of comments, especially from anthropologists, economists, philosophers. They didn't like this at all. Because they had decided that fairness is a very complex issue and that animals cannot have it.

One philosopher wrote that he would believe it had something to do with fairness if the one who got grapes refused them. Now the funny thing is, an experimenter who used chimpanzees had instances where, indeed, the one offered the grape refused it until the other also got one.

So we're getting very close to the human sense of fairness. And I think philosophers need to rethink their philosophy. I think morality is much more than what I've been talking about, but it would be impossible without these ingredients that we find in other primates, which are empathy and consolation, pro-social tendencies and reciprocity and a sense of fairness.

Thus, professor de Waal provides reason to believe that humans, the most highly developed primate, naturally have the social qualities that are necessary for the Fairshare Model to work.

What Does Adam Smith Say About Human Nature?

In 1776, the year America declared its independence, Scottish economist and philosopher Adam Smith published *An Inquiry into the Nature and Causes of The Wealth of Nations*. This book, known as *The Wealth of Nations,* is the cornerstone of classic economic thought, where market forces are a likened to an "invisible hand." Less known is his 1759 book, *The Theory of Moral Sentiments* which explores the moral underpinnings for commerce, the "system" that came to be known as "capitalism."

Economist Russ Roberts is a fellow at Stanford University's Hoover Institution. In 2014, he authored a book, *How Adam Smith Can Change Your Life: An Unexpected Guide to Human Nature and Happiness.* In it, he writes that *The Theory of Moral Sentiments* "was Adam Smith's attempt to explain where morality comes from and why people can act with decency and virtue even when it conflicts with their own self-interest. It's a mix of psychology, philosophy, and what we now call behavioral economics, peppered with Smith's observations on friendship, the pursuit of wealth, the pursuit of happiness, and virtue. Along the way, Smith tells his readers what the good life is and how to achieve it."

Defenders of convention in the capital formation process—today's high valuations and the way Wall Street IPOs are allocated—may be taken aback when Roberts reports that "Smith wrote on the futility of pursuing money with the hope of finding happiness."[120] To those who believe capitalism is about self-interest and that "greed is good", Roberts lets it be known that there is nothing about that in *The Wealth of Nations* and the opposite is true in *Theory of Moral Sentiments*, which minimizes the importance is constantly seeking fame, power and money. He offers this quote from the first page of *Theory of Moral Sentiments* leads me to think that Adam Smith and John Donne shared views about human nature.

> *How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.* [121]

Roberts says that Smith felt that, deep down, what humans really want is to love, to be loved and to be admired. And, that these motivations are the foundation of civilization. By the way, Roberts is rather hip for an economics professor. He hosts Econtalk (www.econtalk.org), a podcast on economic matters. He also helped create a YouTube video in which dueling views on the nature of economic cycles are delivered in rap-style. From a personal perspective, he writes "Smith helped me understand why Whitney Houston and Marilyn Monroe were so unhappy and why their deaths made so many people so sad. He helped me understand my affection for my iPad and my iPhone, why talking to strangers about your troubles can calm the soul, and why people can think monstrous thoughts but rarely act upon them. He helped me understand why people adore politicians and how morality is built into the fabric of the world."[122]

Roberts also writes "Economics helps you understand that money isn't the only thing that matters in life. Economics teaches you that making a choice means giving up something. And economics can help you appreciate complexity and how seemingly unrelated actions and people can become entangled."[123]

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[120] "How Adam Smith Can Change Your Life " by Russ Roberts, page 3
[121] Ibid, page 3
[122] Ibid, page 5
[123] Ibid, page 13

Common Purpose is what you make it

You might believe that cooperative micro-networks are an advantage for a company, and, that a model that encourages cooperation would appeal to investors and workers. You might also believe that it is natural for people to want to cooperate and still wonder what the objectives of the cooperation might be. What would be the common purpose?

In the Fairshare Model common purpose, the measures that convert Performance Stock to Investor Stock, can be whatever the participants agree that it will be! And, it can change as often as they want it to change.

The measure of common purpose will vary by company, and it can change over time. Classic measures would be revenue, margin and profit. But, those may be insignificant for a young company and not applicable to a start-up that seeks capital to develop its product. It could be development of intellectual property, a product release, measures of customer satisfaction, securing new financing on favorable terms. It could even include a community based measure of value like the number of jobs or environmental impact.

Isn't "Maximization of Shareholder Value" the Common Purpose?

"Are you a socialist?" Someone asked me that after seeing concept material that I had online about the Fairshare Model. The idea that employees could vote on shareholder matters and share in the return on capital prompted his question. I'm not a socialist; I'm a capitalist who is seeking a better deal for public investors in venture-stage companies. And, I think that a capital system that emphasizes fairness, embraces empathy and promotes cooperation—that is, the Fairshare Model—has the potential to help its adopters outperform those that rely on one that doesn't (i.e., a conventional capital structure).

That said, the question begs other, larger ones. Such as "Who does a corporation owe a duty to?" and "Are some stakeholders more important than others?" A company's constituencies are varied; shareholders, the CEO, other employees, customers, suppliers and the communities it operates in. How do they rank in priority?

Under U.S. bankruptcy law, when a company enters a "zone of insolvency", its board of directors and management must place the interests of creditors before shareholders or anyone else. An enterprise can be in this zone when its current assets (cash, accounts receivable, inventory) exceeds its current liabilities. In other words, when it lives hand-to-mouth from a cash perspective; they lack the ability to pay their obligations in full and in the ordinary course of business.

This becomes interesting when one considers that many venture-stage companies reside much of the time in the zone of insolvency. Their hope of moving to a better neighborhood rests on confidence that investors or lenders will provide the capital that allows them to be solvent—this includes the willingness of creditors to wait for payment. Therefore, if such a corporation were a person, it might be cast as Blanche DuBois, the character in Tennessee William's *A Streetcar Named Desire* who utters the line "I have always depended on the kindness of strangers."[124]

Put that thought to the side though. There is a deeper question to contemplate, "How do the stakeholder's rank in priority when a company is not financially distressed?" Jack Ma, the CEO of Alibaba famously said that his ranking is "Customers first, employees second and shareholders last." He didn't have a place for creditors. That may be because in 2014, his Chinese company (actually, a Cayman Island affiliate) had the largest IPO in the history of the U.S. (or the world).

Like me, Dear Reader, you may be aware of management teams who operate as if their interests trump everyone else's; they're more important than those of customers, other employees, creditors or shareholders. This world view is rarely articulated. When it is, it is usually as a justification for exposed behavior. I don't recall a CEO advancing "It's all about me!" as a legal or business theory on priority but I've seen evidence that some believe it.

[124] In his 2012 presidential campaign, Mitt Romney declared that "corporations are people too"—a position consistent with the U.S. Supreme Court's 2010 decision in the *Citizen's United* case which found that corporations have a constitutional right to exercise free political speech (i.e., give unlimited money to political causes).

Common wisdom is that a corporation's highest duty is to maximize the interests of its shareholders.

Washington Post business columnist Steven Pearlstein challenges that orthodoxy in a brilliant 2013 piece entitled *How the Cult of Shareholder Value Wrecked American Business.* I recommend that you read the entire article but excerpts are below [bold added for emphasis].[125]

> ***In the history of management ideas, few have had a more profound — or pernicious — effect than the one that says corporations should be run in a manner that "maximizes shareholder value."*** *Indeed, you could argue that much of what Americans perceive to be wrong with the economy these days — the slow growth and rising inequality; the recurring scandals; the wild swings from boom to bust; the inadequate investment in R&D, worker training and public goods — has its roots in this ideology.*
>
> *The funny thing is that* ***this imperative to "maximize" a company's share price has no foundation in history or in law. Nor is there any evidence that it makes the economy or the society better off.*** *What began in the 1970s and '80s as a corrective to managerial mediocrity has become* ***a corrupting, self-interested dogma peddled by finance professors[126]****, money managers and over-compensated corporate executives.*
>
> *[Apparently, no law requires] that executives and directors owe a special fiduciary duty to shareholders.* ***How then did "maximizing shareholder value" evolve into such a widely accepted norm of corporate behavior?*** *The most likely explanations are* ***globalization and deregulation,*** *which together rob many major American corporations of the outsize profits they earned during the "golden" decades after World War II. Those profits were enough to satisfy nearly all the corporate stakeholders. But in the 1970s, when increased competition started to squeeze profits, it was easier for executives to disappoint shareholders than their workers or communities.*
>
> *No surprise, then, that by the mid-1980s, companies with lagging stock prices found themselves targets for hostile takeovers by rivals or corporate raiders using newfangled "junk" bonds to finance their purchases. Disgruntled shareholders were willing to sell. And so it developed that the threat of a possible takeover imbued corporate executives and directors with a new focus on profits and share prices, tossing aside inhibitions against laying off workers, cutting wages, closing plants, spinning off divisions and outsourcing production. Today's "activist investor" hedge funds are the descendants of these 1980s corporate raiders.*
>
> *While it was this new "market for corporate control" that created the imperative to boost near-term profits and share prices, an elaborate institutional infrastructure has grown up to reinforce it. This infrastructure includes business schools that indoctrinate students with the shareholder-*

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[125], "How the cult of shareholder value wrecked American business" by Steven Pearlstein, Washington Post, Sept. 9, 2013, http://wapo.st/18Kr1yY

[126] The seminal role that university finance professors played in promoting the policies that led to the Great Recession was highlighted in Charles Ferguson's Academy Award winning 2010 movie, *Inside Job*. It reports how eminent academics have made fortunes from Wall Street since the 1980s while advocating its interests in regulatory proceedings, the courts and in the media. A number promoted positions as objective experts while failing to disclose that they earned considerable sums from those who benefit from their policy prescription. Ferguson draws an ethical comparison to a physician who promotes the benefit of a drug as a medical expert but fails to disclose that he/she has been paid large sums by the company making the drug.

first ideology and equip them with tools to manipulate earnings and share prices. It includes lawyers who advise against any action that might lower the share price and invite shareholder lawsuits, however frivolous. It includes a Wall Street that is fixated on quarterly earnings, quarterly investment returns and short-term trading. And most of all, it is reinforced by pay packages for executives that are tied to the short-term performance of the company stock.

The result is ***a self-reinforcing cycle in which corporate time horizons have become shorter and shorter****. The average holding periods for stocks, which for decades was six years, is now less than six months. The average tenure of a public company CEO is less than four years. And the willingness of executives to sacrifice short-term profits to make long-term investments is rapidly disappearing.*

The real irony surrounding this focus on maximizing shareholder value is that it hasn't, in fact, done much for shareholders. One thing we know is that less and less of the wealth generated by the corporate sector was going to frontline workers. *Another is that more of it was going to top executives.* ***Almost all of that increase came from stock-based compensation.***

One problem is that it's not clear which shareholders it is whose interests the corporation is supposed to optimize. *Should it be the hedge funds that are buying and selling millions of shares every couple of seconds? Or mutual funds holding the stock for a couple of years? Or the retired teacher in Dubuque, Iowa, who has held it for decades?*

Even as [corporations] proclaim their dedication to shareholders, they have been doing everything possible to minimize and discourage shareholder involvement in corporate governance. This hypocrisy is recently revealed in the effort by the business lobby to prevent shareholders from voting on executive pay or to nominate a competing slate of directors.

For too many corporations, "maximizing shareholder value" has provided justification for bamboozling customers, squeezing suppliers and employees, avoiding taxes and leaving communities in the lurch. For any one profit-maximizing company, such behavior may be perfectly rational. But when competition forces all companies to behave in this fashion, it's hardly clear that society is better off. Perhaps the most ridiculous aspect of "shareholder uber alles" is how at odds it is with every modern theory about managing people. *David Langstaff, CEO of TASC, a government contracting firm, put it this way:*

> ***"If you are the sole proprietor of a business, do you think that you can motivate your employees for maximum performance by encouraging them simply to make more money for you? Of course not. But that is effectively what an enterprise is saying when it states that its purpose is to maximize profit for its investors."***

These days, ***economies have been scrambling to explain the recent slowdown in the pace of innovation and the growth in worker productivity. Is it possible it might have something to do with the fact that workers now know that any benefit from their ingenuity or increased efficiency is destined to go to shareholders and top executives?***

The defense you usually hear of "maximizing shareholder value" from CEOs is that most of them don't confuse this week's stock price with shareholder value. They acknowledge that no enterprise can maximize long-term value for its shareholders without attracting great employees, *producing great products and services and doing their part to support effective government and healthy communities. In short, they argue, there is no inherent conflict between the interests of shareholders and those of other stakeholders.*

But ***if optimizing shareholder value requires taking care of customers, employees and communities, then you could argue that "maximizing customer satisfaction" would require taking good care of shareholders, employees and communities.*** *And, indeed, that is the suggestion made by Peter Drucker, the late, great management guru. "The purpose of business is to create and keep a customer," [he] wrote.*

It is no coincidence that companies that maintain a strong customer focus — think Apple, Johnson & Johnson and Procter & Gamble — have done better for their shareholders than companies which claim to put shareholders first. The reason is that customer focus minimizes risk taking and maximizes reinvestment, creating a larger pie from which everyone benefits.

Most executives would be thrilled if they could focus on customers rather than shareholders. In private, they chafe under the quarterly earnings regime forced on them by asset managers and the financial press. They fear and loathe "activist" investors who threaten them with takeovers. And they are disheartened by their low public esteem.

If it were the law that was at fault, that would be easy to change. ***Changing a behavioral norm*** *— one reinforced by so much supporting infrastructure —* ***turns out to be much harder****.* ***The challenge facing the "corporate social responsibility" movement is that it exhibits an unmistakable liberal bias that makes it easy for academics, investment managers and corporate executives to dismiss it as ideological and naïve.***

My guess is that it will be a new generation of employees that finally frees the American corporation from the -shareholder-value straightjacket. *Young people — particularly those with skills that are in high demand — today are drawn to work that not only pays well but also has meaning and social value. As the economy improves and the baby boom generation retires, companies that have reputations as ruthless maximizers of short-term profits will find themselves on the losing end of the global competition for talent.* ***In an era of plentiful capital, it will be skills, knowledge, creativity and experience that will be in short supply, with those who have it setting the norms of corporate behavior.***

How might people respond to debate about what common purpose for a corporation should be? For some, it will be disorienting to consider that maximizing shareholder value isn't the sole answer. For others, it will be liberating.

The ability, indeed, the responsibility, to define common purpose seems a bit daunting. In some ways, it is more stressful to have a choice than to have it already defined. In this sense, those who use "maximize shareholder value" have had it easy.

What's clear is that more than one answer is possible, and, that the rationale for the conventional one is not as strong as many may think.

Diversity in Common Purpose

Steven Pearlstein deconstructs a precept that is central to defenders-of-the-way-things-are. The notion that the *only* purpose of a corporation is to advance the interests of its shareholders. Increasingly, there are people who want new thinking about corporate purpose, which is an expression of common purpose. In a way, this is like people who like athletics finding value in something other than winning.

A "benefit corporation" or "B corp" for short, is an example of this. It is a new class of corporation; one whose charter includes a duty to benefit society. Since 2010, nearly thirty U.S. states have authorized them. The accounting and tax rules are the same as for a regular corporation, also known as a "C corp." What is different is that directors in a B corp have a duty to consider the interests of all "stakeholders"—shareholders, employees, suppliers, customers, community and environment—when deciding matters. The *New Yorker* expands on this: [127]

> In 2013, B Corp Rally Software went public with a valuation of $315 million, raising $84 million. In 2015, Etsy became the largest B Corp to have an IPO; it raised $267 million at a valuation of $1.8 billion.

Whereas a regular business can abandon altruistic policies when times get tough, a benefit corporation can't. Shareholders can sue its directors for not carrying out the company's social mission, just as they can sue directors of traditional companies for violating their fiduciary duty. Becoming a B corp raises the reputational cost of abandoning your social goals. It's what behavioral economists call a "commitment device"—a way of insuring that you'll live up to your promises. Being a B corp also insulates a company against pressure from investors.

Since the nineteen-seventies, the dominant ideology in corporate America has been that a company's fundamental purpose is to boost investor returns: as Milton Friedman put it, increased profits are the "only social responsibility of business." Law professors still debate whether or not this is legally true, but most CEOs feel huge pressure to maximize shareholder value. At a B corp, though, shareholders are just one constituency. [The clothing company] Patagonia doesn't need to worry about investors' opposing its environmental work, because that work is simply part of the job. For similar reasons, benefit corporations are far less vulnerable to hostile takeovers. When Ben & Jerry's was acquired by Unilever, in 2000, its founders didn't want to sell, but they believed that fiduciary duty required them to. A benefit corporation would have had an easier time staying independent.

In his full Washington Post article, Pearlstein argues for tax and regulatory reforms that "help the corporate ecosystem become more heterogeneous." Biodiversity is good for the planet and social diversity creates a more vibrant, interesting society. It makes similar sense to promote diversity in the purpose of capitalist enterprises. Pearlstein says we ought to encourage "different companies taking different approaches and adopting different priorities." Because, "In the end, 'the market'—not just the stock market, but product markets and labor markets as well—would sort out which worked best."

To wit, the Fairshare Model presents a different approach to how capital is raised and employees are compensated; it supports heterogeneity in how common purpose is defined but does not require a corporation to be "good." It calls for conscious agreement on how performance is defined and measured.

[127] "Companies With Benefits", by James Surowiecki, The New Yorker, Aug. 4, 20014 http://www.newyorker.com/magazine/2014/08/04/companies-benefits

A Common Purpose Panorama

Now, let's open the view on how the Fairshare Model addresses the common purpose challenge. To begin with, most companies that adopt the model will use shareholder value to measure performance. It is the best understood and accepted performance measure. Indeed, it can be a "gimme", enabling a company to say to its IPO investors, "If the market value of Investor Stock climbs from the IPO price, that's performance, or, evidence that you got a below market deal—either way, the Performance Stockholders get a reward." More on this in the next chapter.

Also, companies will have additional measures of common purpose—performance that generates conversions. They can be legal, technical, marketing or financial accomplishments—even measures of accomplishment that are social or environmental oriented. Plus, they can change it as they see fit. So here, common purpose is not a top-down Big Solution, nor does it require buy-in from a broad number of people. Instead, it's a bottoms-up micro-solution, formed by those who choose to deal with the issue. As a result, there is no large social or policy matter to argue about—it is live and let live.

However common purpose is defined, the Fairshare Model requires that it be *between* the issuer and the shareholders of Investor Stock and Performance Stock. So, the model strikes a bargain based on how the parties define performance—which is their common purpose. Issuers will vary in how *they* define it, but guidelines will emerge. They will vary based on the issuer's industry—software vs. food vs. industrial vs. service vs. biotech vs. service businesses—and stage of development. And, they may be applied differently based on the geography and other factors. For this reason, the model will be associated with diversity in what the purpose of a corporation is.

The model requires common purpose *between* the Investor and Performance Stockholders. What about *within* the Performance Stock pool? Investor Stock shareholders may have little interest in this—time and experience will tell. At this stage, one can only imagine the potential of Performance Stock to build common purpose. Once there is broad interest in the model, experts in law, tax, organizational behavior and other areas will assess this matter. For now, contemplate these ideas:

- **Employees** -- Strategies to motivate employees often rely on team-building and creative thinking exercises. Their effectiveness fades as the novelty passes. Financial incentives have an enduring effect, so it is surprising that they are often overlooked. A Performance Stock program has the potential to foster common purpose and performance much like Q.T. Wiles innovative system did.

- **Suppliers** -- "Lean systems" have ways to build common purpose in a supply chain but its relatively rare (in the U.S., anyway) for a company to offer suppliers equity in itself as incentive. An interest in Performance Stock, possibly a non-voting version, could provide a start-up a way to add more win-win aspects to the relationship.

- **Investors** –Performance Stock could be a "sweetener" for pre-IPO investors, providing incentive to support a low IPO valuation and the conversion rules. Also, it could be used to attract investors who can help the issuer but don't manage an investment fund. For instance, an angel investor group might be persuaded to advise the issuer in exchange for a chunk of Performance Stock. Their involvement could comfort other investors; they would be positioned to advise an unproven entrepreneurial team without having the legal exposure associated with being on the board of directors.

Performance Stock will present accounting and tax issues that will need to be evaluated by experts if there is a market for the Fairshare Model. In a later chapter, I'll have some things to say about the accounting implications. But here, I just want to encourage creative thinking about how it can be used to foster cooperation among links in an enterprise's value chain, its micro-networks.

Investor Stock can be used to promote common purpose too. Because it is sold in a public offering, anyone can buy shares. As a result, entrepreneurs that promote social good in their business have more investors to appeal to for support. Businesses that don't have this focus can nonetheless make their Investor Stock available to customers and suppliers.

The focus of these points about common purpose is the issuer and its micro-networks, not society-at-large. But, small solutions can help address big problems like weak economic growth and rising income inequality. With that thought in mind, reflect on what U.S. Secretary of Labor Thomas Perez had to say before the National Press Club on October 20, 2014:

> *I'm confident that we can construct a fair way to share prosperity in which everybody has a chance to live their highest and best dreams. And that's what I want to talk to you about.*
>
> *This stairway has a number of important steps. Starting with tearing up the talking points and understanding history. Shared prosperity is not a fringe concept, cooked up by socialists. Historically, both parties have embraced it in both their words and, indeed, their actions. It's a principle that is as American as apple pie and is the linchpin of a thriving Middle Class.*
>
> *Here's what Teddy Roosevelt said. "Our aim is to promote prosperity and then to see that that prosperity is passed around and there is a proper division of that prosperity." Lloyd Blankfein, CEO of Goldman Sachs, talked about the destabilized effects of income inequality and said "Too much of the GDP over that last generation has gone to too few of the people." Standard and Poors recently issued a report saying that income inequality is stifling GDP growth at a time when we're still climbing out of the Great Recession. Federal Reserve chairman Janet Yellin said "The extent of the continuing increase of inequality greatly concerns me."*[128]

Onward

This chapter was about cooperation and common purpose. There is evidence that people (and animals) thrive when it exists. There is also reason to believe that companies that have a high degree of it in their micro-networks outperform those who have less of it.

The next chapter will examine the quintessential difference between a conventional capital structure and the Fairshare Model—how they deal with uncertainty. It will also discuss the causes of uncertainty.

[128] http://www.c-span.org/video/?322184-1/labor-secretary-thomas-perez-us-economy

Chapter 11: The Tao of the Fairshare Model

Preview

- Preview
- Foreword
- A Different Approach to Uncertainty
- Uncertainty Illustrated
- The Treatment for Uncertainty–Multiple Classes of Stock
- Negative vs. Positive Energy
- Onward

Foreword

Taoism (or Daoism) is an ancient Chinese philosophy about indefinable truths underlying the universe, which are revealed in the natural order of things. Tao (or Dao) has multiple meanings but, broadly, it is a path, an appropriate way to behave and to lead others.

Ultimately, one's tao is about balance; sensing what is missing and restoring it. Everyone has their own tao and finding it requires meditative and moral exploration.

This chapter describes the tao of the Fairshare Model—its approach to living in harmony with the uncertainty that inherent when bringing equity capital into a venture stage company. The Fairshare Model's tao—its sense of the natural order of things—is at odds with the tao of a conventional capital structure, at least the kind that are presented to public investors. That's because such a deal structure offers public investors far less protection from uncertainty than it offers venture capitalists.

On the other hand, the tao of the Fairshare Model is similar to the tao of conventional capital structure used by venture capitalists. Each seeks to balance uncertainty of performance with uncertainty of ownership. Each does it differently but that's because their audiences are different—the VC model is for accredited investors, while the Fairshare Model is for public investors.

This chapter contrasts how the uncertainty is resolved. It will also show how the Fairshare Model relies on positive energy to align the interests of investors and employees. And, it will discuss **the most astonishing aspect of the Fairshare Model—that entrepreneurs become indifferent about their IPO valuation. In fact, they have incentive to make it low.** Thus, it has the potential to transform the relationships between an issuer, its investors and employees in a positive way.

A Different Approach to Uncertainty

A reminder as we begin, the Fairshare Model is for a public offering, one that anyone can invest in. Its goal is to emulate the deal structure that VCs rely on when they invest in a private offering.

The Fairshare Model differs from a conventional capital structure in how it deals with uncertainty. *Uncertainty is inescapable* when balancing ownership interests and performance risk. And it can be a struggle for a company and investors to find agreement on who bears the risks of uncertainty. Any agreement reflects an answer this question…***Is it better to define the ownership interests of insiders before or after performance is delivered?*** Or, put another way…***Who should bear the risk of uncertainty, should it be insiders (employees and existing investors) or should it be new investors?***

Those who believe that ownership interests should be set before performance is delivered, that the uncertainty of future performance should be borne by new investors, will favor a conventional capital structure. They presume a Next Guy who is eager to assume the uncertainty at a higher valuation.

Those who see benefit from defining ownership interests after performance is delivered or feel that the risk of uncertainty should be borne by insiders (employees and pre-IPO investors) will be intrigued by the Fairshare Model.

In a conventional capital structure, the principal bet is on what future performance will be.

In the Fairshare Model, the principal bet is on human behavior—will shareholders agree on how to reward performance?

The essential difference between the two is *when* the ownership split is decided—before or after performance is established. Let's consider the distinction with a simple example and visual devices.

Assume that a company raises $5 million from investors in exchange for half the company. Using a conventional capital structure, the new investors and employees (a/k/a founders) agree that the issuer's *pre-money* valuation is $5 million (i.e., before the investor money is received). As shown below, after the new investor's money is raised, the *post-money* valuation is $10 million.

	Valuation	Ownership
Pre-Money Valuation (Employees)	$ 5 million	50%
Money (New investors)	5 million	50%
Post-Money Valuation (Combined)	$10 million	100%

A puzzle? Not to worry! The narrative explains what you need in order to grasp the tao of the Fairshare Model. Plus, valuation is explained in Section III, which begins after this chapter.

So, the parties have established certainty with respect to ownership—they agree the new investors get half of the equity. In doing so, the parties effectively agree that the *present value*[129] of the company's future performance is $5 million, even though it is little more than an idea (i.e. no performance so far). This is an important point to keep in mind.

[129] "Present value" is the value today of a future stream of income or cash, discounted for risk and time. A dollar that you get in five years is worth less than a dollar today—that's the present value.

The post-money valuation of $10 million is the sum of the value of future performance ($5 million) and the $5 million investment. No one knows what the performance will be or what the valuation will be in the next round, when the company needs more money. The bet, the uncertainty, hinges on whether the company will meet expectations and what market conditions will be.

It doesn't matter how the parties came to value future performance at $5 million. They may have relied on a generally accepted multiple of something (projected revenue, earnings, etc.). Social considerations may have played an influence. All that matters is that the deal assumes that the company is worth $5 million before the new investors invest.

So, we have certainty regarding ownership and uncertainty about what the performance will be worth. The investors will suffer if the company is worth less than $10 million in the next round. If that happens, they overpaid. Why? Their $5 million was worth that before they bought the company's stock. Therefore, if the next round valuation is less than $10 million, the basis for the $5 million pre-money valuation in the first round was overpriced!

For example, if the next round values the company at $8 million—$2 million less than the $10 million—the first round investors should have gotten more than 50% of the ownership or they should have only paid $4 million for half. Less apparent, first round investors may feel that they overpaid even if the next valuation is above $10 million. If their target rate of return is 15% and the next round valuation delivers 5% appreciation, they will be unhappy.

To be sure, uncertainty affects the founders too, but in a different way. They may have wistful regret if their idea/performance turns out to be worth much more in the second round. For instance, if the second round valuation is $20 million dollars, they may ask…*Weren't we worth more than $5 million in the first round? Did we sell too cheap?*

Chances are, though, that the founders will not beat themselves up too much about the first round valuation because it is water under the bridge. Besides, there are ways to rationalize it. They may not have gotten where they did without that money or there may have been the best option at the time. Besides, if the next round investors must feel that they can meet their target return at a valuation that is lot higher than $10 million, everyone is happy!

Investors are reportedly begging Warby Parker to let them invest at a billion-dollar valuation

Source- Business Insider, March 2015

This is certainly not the fabulous exit that Fab was hoping for. The ecommerce service once valued at nearly $1 billion has been acquired for about $15 million.

Source- Mashable, March 2015

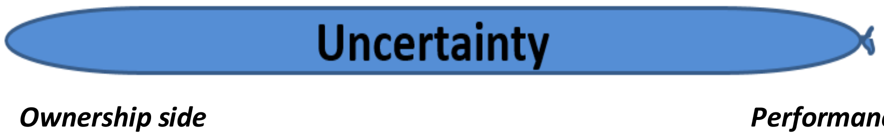
Nextdoor, which runs a social network for people to interact with others who live in their physical neighborhoods, is the latest private tech company to join the swelling ranks of the billion-dollar valuation club.

Source—Techcrunch, March 2015

Uncertainty Illustrated

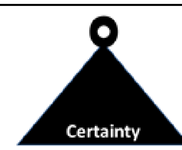
To grasp the tao of the Fairshare Model, imagine a long balloon, the kind that looks like a hot dog and can be twisted into animals and other sundry shapes. But instead of air, this balloon is full of uncertainty.

The left end of this balloon represents ownership interests in a venture-stage company, while right end represents certainty about its future performance.



And what is a venture-stage company? Regardless of whether it is privately held or publically traded, it is one that has the following risk factors for investors:

- Market for its products/services is new/uncertain
- Unproven business model
- Uncertain timeline to profitable operations
- Negative cash flow from operations; *it requires new money from investors to sustain itself*.
- Little or no sustainable competitive advantage
- Execution risk; team may not build value for investors



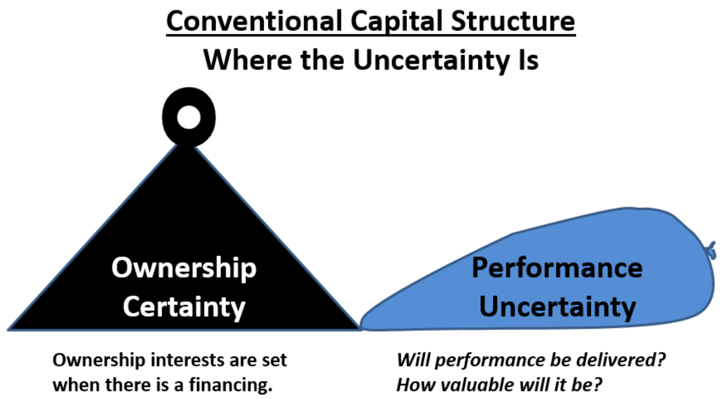
Certainty is symbolized by a weight

Pressing down on the balloon creates certainty, but it does not eliminate uncertainty. Certainty in one area does not reduce the volume of uncertainty, it simply moves it. A weight symbolizes certainty in our imagery. Placing the weight one end of the balloon creates certainty there but causes uncertainty to bulge on the other end.

This is a way to show that when a venture-stage company raises equity capital, uncertainty can be moved but it can't be eliminated. This is true whether the funds come from accredited investors in a private offering or from public investors in an IPO.

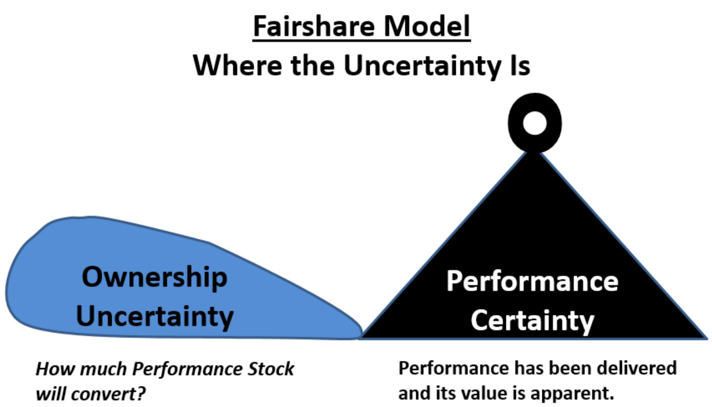
The balloons on the next page will help you visualize the essential difference between a conventional capital structure and the Fairshare Model. It is all about *when* the ownership split for investors and employees is decided—before or after performance is established.

The following balloon portrays what happens in conventional capital structure. Ownership interests are set at the time of an equity financing—the ownership spilt between employees and investors is set. It is symbolized by the certainty on the ownership end of the balloon. The creation of certainty there pushes the uncertainty to the performance end of the balloon.



Will it deliver its new product as expected? What will the market response be to the product? The answers to these question, surely, would influence the ownership outcome if they were known when it was being negotiated. But, in a conventional deal, the kind offered to public investors, ownership must be decided before the answers are known.

What happens in the Fairshare Model, as the next balloon shows, performance has been delivered and its value is more or less apparent. That is why the weight of certainty is on the performance end of the balloon. Placing it there moves the uncertainty to the ownership end.



Here, the uncertainty centers on how much Performance Stock will convert. Will the criteria to convert Performance Stock match the performance delivered? If there is a disagreement between the Investor Stock and Performance Stock shareholders, how will it be resolved? If either or both classes of stockholders feel the criteria for conversion needs to change, will they be able to agree on new criteria?

In the Fairshare Model, employees don't get Investor Stock for *future performance*, but, they do get it for *past performance*. Also, future performance can be presumed, as discussed in chapter six, but the conversions happen quarterly, not up-front.

The Treatment for Uncertainty–Multiple Classes of Stock

There is no panacea for the uncertainty inherent in a venture-stage company investment, but there is a way to treat it. It involves the use of multiple classes of stock to structure control and economic interests. Venture capital and private equity firms require companies that they invest in to have a capital structure (albeit a conventional one) with multi-classes capital of stock.[130]

It is unusual, however, for an issuer to have multiple classes of stock in a public offering. When it occurs, it is to create extra voting or dividend rights for particular pre-IPO shareholders. *The Fairshare Model is novel because it uses a multi-class capital structure to protect the interests of public investors*.

Return to our example; a new company raises $5 million at a pre-money valuation of $5 million, which makes its post-money valuation $10 million; employees and investors each own half of the company. Now, we will examine how the *ownership split* (here, an easy 50-50) affects the *ownership payoff* when the company is acquired a year later. We will first look at the ownership payoff for a company with a single class of stock, then for a company with two classes of stock.

For the single stock scenario, assume that the $5 million is raised in an IPO. Again, virtually all companies go public with a single class of stock, plus, this sets up a contrast to the Fairshare Model. Also assume that no one has sold stock since the IPO, as this facilitates measurement the ownership payoffs when the acquisition price is good ($30 million), mediocre ($12 million) and poor ($2 million).

	Good Price	**Mediocre Price**	**Poor Price**
Acquisition Price	**$ 30 Mil**	**$ 12 Mil**	**$ 2 Mil**
Public investors			
50% ownership split	$ 15 Mil	$ 6 Mil	$ 1 Mil
Less: investment	(5 Mil)	(5 Mil)	(5 Mil)
Ownership payoff	**$ 10 Mil**	**$ 1 Mil**	**($4 Mil)**
Employees			
50% ownership split	$ 15 Mil	$ 6 Mil	$ 1 Mil
Less: investment	None	None	None
Ownership payoff	**$ 15 Mil**	**$ 6 Mil**	**$ 1 Mil**

Put off by a table of numbers? Then skim this and the next one. The numbers are not important here, the narrative is.

As the above table shows, in each scenario, employees do better than investors. This makes sense in the good price scenario, after all, their performance generated $20 million in enterprise appreciation ($30 million acquisition price less $10 million post-money valuation).

However, in the mediocre price scenario, the enterprise appreciation was only $2 million, which suggests the IPO valuation was too high. Nonetheless, employees get half the proceeds from the $12 sale because they have half the ownership interest (which cost them nothing). This leads to an egregious outcome—the ownership payoff for employees is $6 million and $1 million for investors, who had to pay $5 million for their 50% ownership stake.

In the poor price scenario—there is an $8 million loss in enterprise value ($10 million post-money valuation less $2 million price), yet employees get $1 million and investors lose $4 million.

[130] Private Equity (or PE) is a superset of venture capital: all VC firms are a form of PE. VCs focus on private, early-stage companies while PE firms invest in established businesses, both private and public.

Bizarre ownership payoffs like those in the mediocre and poor scenario occur when capital is raised using a capital structure with a single class of stock. It happens when a triad of conditions co-exist:

1. Ownership interests are issued upfront for future performance.

2. A value is placed on future performance.

3. *The same type of ownership interest is issued for future performance as for capital.* In other words, the same class of stock is issued new investors as to insiders. More specifically, IPO investors get the same class of stock—common—that founders, other employees and pre-IPO investors get.

The odds of an unfair outcome increases when a fourth condition is present.

4. Very high value is assigned to the company's future performance—one defined more by what is "possible" than by what is likely, at least in the near term.

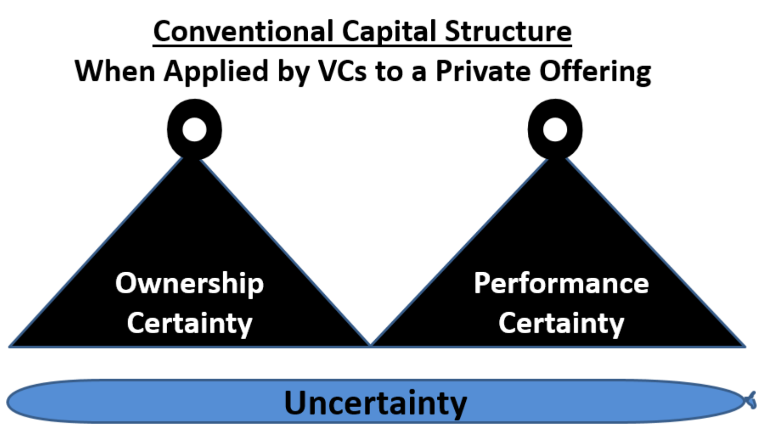
The first three conditions are the ones to focus on because they create the signature. The fourth one amplifies the risk for investors; I'll ignore it here to zero in on the essential point. The first three conditions are present in a public VC-backed company. But, *the third condition does not exist in a private VC-backed company*; there, different ownership interests are issued for capital and future performance.

Put another way, *the capital structure used in a public VC-backed company is unacceptable to a VC when it is private*. Same company, same risks--everything the same except for whether the company is public or private. If it is public, conditions one, two and three are okay. If it is private, condition one and two are okay—condition three is unthinkable!

To appreciate the significance of this dichotomy, recognize that a capital structure determines how the risks and rewards are allocated. If a corporation were a car, its capital structure would be its chassis; if the enterprise was a house, it would be the load-bearing structure; if it were a country, it would be its constitution.

How ownership payoffs are distributed is a function of the capital structure. So, why do VCs refuse to invest in a private company that has condition three?

Because, as illustrated to the right, the way they deal with the uncertainty of future performance is to create uncertainty about ownership!



VCs suspend the weight of ownership certainty until there is performance certainty. Their deal terms enable them to retroactively increase ownership if a company falters and expand their ownership when it looks like a winner.

VCs have an array of tools to create uncertainty with respect to ownership interests. For employees, they require vesting schedules for stock issued for ideas and future performance. Shares already owned by employees may be subject to buyback or forfeiture agreements.[131] For angel investors—individuals who invest before the VC—a VC's deal terms can create uncertainty of ownership through devices that may reduce their ownership interest and/or the ownership payout. My purpose here isn't to argue whether VCs treat employees and angel investors fairly or not. It's to point out that *VCs use complex capital structures to deal with uncertainty.*

Accordingly, let's consider what a conventional capital structure looks like in a privately held VC-backed company. To begin with, it has multiple classes of stock. Common stock is issued to employees and other classes are issued for capital. Even when common stock is the largest class of stock, the VC's stock may be the most powerful from a *control perspective* (i.e., it may have the right to elect a majority of the board of directors or have super voting rights). From an *economic perspective*, a VC will have a priority claim to the issuer's value. Thus, ownership interests in a private, VC-backed company have an apparitional quality—it may look one way from a percentage of shares perspective and be very different from a control and economic perspective.

Now, assume that the $5 million in our example is raised from a VC. Like before, employees own half the shares. The table below has the same acquisition price range as before. It also assumes that the VC has special rights—liquidity preference, dividends, expense reimbursement and management fees—that give it priority to the first $10 million of the price. What is left is split evenly between the VC and employees.

	Good Price	**Mediocre Price**	**Poor Price**
Acquisition Price	**$ 30 Mil**	**$ 12 Mil**	**$ 2 Mil**
VC's 2X liquidity preference	($10 Mil)	($10 Mil)	($2 Mil)
Available for 50-50 ownership split	$20 Mil	$ 2 Mil	None
VC investor			
Liquidation preference (from above)	$ 10 Mil	$ 10 Mil	$ 2 Mil
50% ownership split	10 Mil	1 Mil	None
Less: investment	(5 Mil)	(5 Mil)	(5 Mil)
Ownership payoff	**$ 15 Mil**	**$ 6 Mil**	**$ (3 Mil)**
Public investor outcome in prior table	$ 10 Mil	$ 1 Mil	$ (4 Mil)
How much better VC does	**$ 5 Mil**	**$ 5 Mil**	**$ 1 Mil**
Employees			
50% ownership split	$ 10 Mil	$ 1 Mil	None
Less: investment	None	None	None
Ownership payoff	**$ 10 Mil**	**$ 1 Mil**	**None**
Employee outcome in prior table	$ 15 Mil	$ 6 Mil	$ 1 Mil
How much worse employees do	**$ (5 Mil)**	**$ (5 Mil)**	**$ (1 Mil)**

[131] There are vesting schedules for stock options too.

The VC's liquidation preference provides priority to the first $10 million. "Liquidation preferences, often seen as an opportunity to juice up the returns, are rights to receive a return prior to common shareholders" [132] when there is a liquidation event, which is what an acquisition is. Here, a 2X liquidation preference gives the VC the right to twice its $5 million investment before other shareholders share the ownership payout. Multiples of one or two are common but sometimes are as high as ten.[133] Another popular way for a VC to boost its ownership payout is to secure a dividend—effectively, interest on their investment that is paid in when there is an IPO or liquidation event.

The point is, a multi-class capital structure is important to a VC. These professional investors demand insurance on the valuation they negotiate, and it is only available when condition three does not exist. A multi-class structure allows them to deal with uncertainty by creating uncertainty for the *ownership interests* of other shareholders. A multi-class structure also enables deal terms that increase their *ownership payout* above what's suggested by their *ownership interest*.

That is what the prior table reflects—the VC's share of the payout is greater than its 50% ownership interest. It also shows that a conventional capital structure deliver significantly different results for investors depending on whether the company has a single-class (public) or a multi-class (private) version of a conventional capital structure.

In the Fairshare Model, employees get Performance Stock for the value of their idea and future performance. In our example, the company raises $5 million based solely on an idea. Realistically, a lot of work goes into developing an idea to where investors will invest $5 million, especially if it is raised in a public offering. So, to make comparison with a conventional capital structure, assume that pre-IPO accomplishments of the employees is worth $200,000. They get Investor Stock for that. Thus, the pre-money IPO valuation is $200,000 and, after the $5 million IPO, there is $5.2 million in Investor Stock available for trading (i.e., assume no change in the price of Investor Stock). Thus, only those who buy Investor Stock or earn it via performance have shares to sell in the secondary market.

By contrast, if the IPO uses a conventional offering with a single class of stock, employees have tradable stock as a result of raising their venture capital in a public offering. This is wealth. It is generated by virtue of getting investors to fund the development of the idea. There may be restrictions on selling the stock, but they expire in a relatively short time. Creating wealth by selling a dream is nearly as old as money itself. But the Fairshare Model is different, wealth creation is tied more to delivering on the promise than selling it.

For their future performance, employees get Performance Stock—a lot! The voting power of Performance Stock is capped at 50%, however, in this example, collectively, employees have 54% of the vote but not control. Performance Stock has 50% of the total vote, plus, employees have 4% of the Investor Stock, a percentage that grows as conversions occur. Ownership payouts when there is good, mediocre or poor acquisition price are in chapter six, Target Companies for the Fairshare Model.

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[132] "The Business of Venture Capital", Mahendra Ramsinghani, John Wiley & Sons (2011), page 239
[133] Ibid

This section gives you a lot to think about, Dear Reader. Let's wrap up it up by reviewing what it has been about. First, it asserts that a multi-class capital structure can resolve uncertainty in a venture stage company. Then it shows how a single class stock structure, the kind used in a public company, can deliver bizarre ownership payoffs when the outcome is mediocre or poor. Three conditions that permit such payoffs are identified. Then, we see why VCs avoid one of them; why they require companies to issue different classes of stock for performance and capital. Finally, it is points out that the Fairshare Model does the same thing.

This table summarizes the three conditions and which capital structures have them.

	Conventional Capital Structure		***Fairshare Model for a public venture stage issuer***
Three conditions that are precedent for the bizarre ownership payoffs in opening example	***VC-backed public company***	***VC-backed private company***	
1. Ownership interests are issued upfront for future performance.	*Yes*	*Yes*	*Yes*
2. A value is placed on future performance	*Yes*	*Yes*	*No*
3. The same type of ownership interest is issued for future performance as for capital	*Yes*	*No*	*No*

All three models have the first condition—all issue ownership interests for future performance.

The second condition? Both the public and private company versions of a conventional capital structure *require* that a value be placed on that performance, but the Fairshare Model does not.

The third condition, the subject of the section, is interesting. Public companies issue the same ownership interest for performance and capital, a single class of stock. That means the financial cost of poor performance is fully borne by those who provide capital; those who have ownership interest for ideas lose an upside, time, effort and a blow to the ego, but they don't lose capital. However, when they invest in a private company, VCs require a multi-class capital structure, as does the Fairshare Model. This condition is interesting in that it isn't generally used to protect public investors in venture-stage companies, but it's *de rigueur* for VCs.

The tao of the Fairshare Model is to reflect how life truly is. For a person, meaning and purpose are revealed over time. For a company, value is revealed by performance.

By changing *when* the ownership split between investors and employees is decided, the Fairshare Model encourages public investors to support risky ventures. That's because it replicates the investor protections VCs insist on for themselves. It is merely a novel application of a proven idea.

A fairer deal for investors and entrepreneurs fosters a more equity funding for venture stage companies. This, in turn, enables entrepreneurs to pursue the Aristotelian *Good Life*. Vicariously, it enables public investors to do the same thing. As such, the model makes them partners, both in substance and spirit.

Negative vs. Positive Energy

Many who have negotiated a round of private capital will attest that the terms of an investment reflect the power of the parties, and, that investors want a low valuation and entrepreneurs want a high one. Getting to agreement often involves a contest of wills. The agreed-upon valuation may have terms that make the deal less attractive if the founders truly understood them. On the other side, an entrepreneurial team may oversell or deceive investors. The negotiation would be one thing if there was a "right answer" on valuation, a truth that can be revealed by argument. But, it is quite another thing because neither side knows what it is now or what it will turn out to be.

Ultimately, if a deal is done, interests are aligned, at least for a while; they fall out of alignment if things don't progress as imagined. The battle over valuation can be renewed and devolve to a struggle for control. The entrepreneurs may lose the ownership that they fought hard to get.

So, in a conventional model investors and the company begin on opposite sides of a negotiating table and may return there if things don't go well. The process has negative energy.

In the Fairshare Model, pre-money valuation isn't a battle—the process has positive energy.[134] There's no struggle between a company and its investors—because they don't begin on opposite sides of the table with respect to valuation. Investors want the valuation to be low, of course. But—this is the amazing part—entrepreneurs don't mind if it's low. In fact, they may want the IPO price low too! Ridiculously low, in the mind of companies that use a conventional model. Alarmingly low, in the mind of competitors.

If a company adopts the Fairshare Model, its directors, executives and other employees don't care what their pre-money IPO valuation is. They are indifferent as to whether it is fifty thousand, five hundred thousand, five million, fifty million or five hundred million…because it doesn't affect their financial position or voting power. **What matters to them is "what does it take for Performance Stock to convert?"**

If a rise in valuation—measured by the aggregate market value of the Investor Stock—is a component of performance, a low IPO valuation is in the interest of both and those new investors of Investor Stock and those who hold Performance Stock. New investors like it—after all, a low buy-in is the first half of "buy low, sell high." Employees like a low IPO valuation of Investor Stock because it makes it easier to meet the market value performance measure! For example, if a 20% rise in Investor Stock value triggers a substantial conversion of Performance Stock, employees will favor an IPO valuation that makes that a no-brainer. They also like it because it makes it more likely that any stock option they have on Investor Stock will be "in the money"—the exercise price for the option is less than the market price of the Investor Stock.

What about those who invest before a Fairshare Model IPO? How might pre-IPO investors think about a low IPO valuation? Not at all supportive, one might think. After all, if they want to "buy low, sell high" as well. It follows that "buy low, sell a bit higher" will have little appeal.

[134] This dichotomy evokes a famous comedy routine performed by the late George Carlin that contrasts baseball and American football. You are sure to laugh even if you have little interest in sports. To view it, do a web search for "Carlin baseball football" or use this link http://www.youtube.com/watch?v=aIkqNiBASfI
The text is here http://www.baseball-almanac.com/humor7.shtml

Here are some reasons why a company's angel investors might be pleased to see a company offer a low valuation with the Fairshare Model.

1. Their company gets the capital it needs….and they don't need to provide it!

    - Angel investors dread having a company that will need more money than they can provide; one that struggles to find investors for the next round.

2. They avoid the threat of an ownership squeeze by that VCs may inflict when there is a down round of financing or other performance targets are not met.

    - A VC's anti-dilution provisions essentially provide it with price protection. If a later transaction lowers the company's valuation, the VC gets more shares for free, reducing its price per share and increasing its ownership share.

    - A "pay-to-play" right allows a VC to investors to invest their ownership share in a new round or lose ownership position and rights.

3. Angel investors tend to have a long-term view on companies that they support. So, the low valuation in a Fairshare Model IPO may not be off-putting, given the first two points.

4. The secondary market price may be substantially higher than the offering price. The Fairshare Model IPO can reflect market value as a Black Friday sale reflects the value of a consumer product.[135] The dynamics of a low-price and small allotments may cause the share price to climb in the secondary market, even if it is a "penny stock."[136]

    - Angel investors may use this opportunity to sell some of their shares.

5. Pre-IPO investors can require Performance Stock as a sweetener for supporting the deal.

6. If pre-IPO investors have warrants on the Investor Stock, they profit from the delta between the warrant exercise price, which will be at the IPO offering price or less, and whatever it rises to in secondary trading. A warrant is essentially a stock option; both are the right to buy stock at the value of the grant date in the future.

7. A Fairshare Model IPO can expand the issuer's micro-network of investors and generate favorable word-of-mouth with customers and others who can help the company succeed. If the price of Investor Stock rises in secondary trading, they will be happy.

8. Employees strive to deliver the performance that triggers conversions. This enhances the ability of the company to attract and retain employees.

So, the most likely objectors to a low IPO valuation—the issuer's pre-IPO investors—have reason to support one, if it is based on the Fairshare Model.

[135] Wikipedia: Black Friday is the Friday following Thanksgiving Day in the U.S. and regarded as the beginning of the Christmas shopping season. Many retailers open very early and offer sales to kick off the shopping season. Violence may occur between shoppers competing for access to the limited supply of deeply discounted items.

[136] Wikipedia: Penny stocks are shares of public companies that trade at low prices per share. In the U.S., a penny stock is one that trades below $5 per share, is not listed on a national exchange, and fails to meet other criteria.

But how about after the raise, when things do begin to go not-so-well? A company is as sure to encounter rough seas as a ship is. Will the positive energy created by being public dissipate? Does the capital structure make a difference in how well a company weathers difficulties? If so, what might be better, a conventional capital structure or the Fairshare Model?

It's speculative to say at this point, as is the ability of companies to raise money using the Fairshare Model. That said, when things don't go well for a company, the Fairshare Model relies on positive energy to solve the problem. Reliably, management will feel pressure to take corrective action from investors but they will be pressured by employees too. After all, their ability to convert Performance Stock depends on working through the trouble—to turn lemons into lemonade.

Troubles may lead to a reexamination of the conversion criteria. This may be difficult, but achievable targets will result. Positive energy can identify pathway to success.

Can the Fairshare Model create the types of incentives that I describe in the last chapter? Could it foster the culture that helped Toyota wildly succeed? Might it be as effective as the management system that turnaround expert Q.T. Wiles used? If so, companies that adopt the Fairshare Model may outperform those that that rely on a conventional capital structure, no matter how well financed they are. For example, a company could tie Performance Stock conversion to a new product release, the acquisition of key customers, customer satisfaction measures, cost reductions, etc. And, to the extent that employees hold the Investor Stock they earn, their interests are further aligned with investors.

The potential to create powerful, dynamic alignment between public investors and employees is the most exciting aspect of the Fairshare Model. It is far, far more significant than the ability to help companies attract low-cost equity capital. This too, is the tao of the Fairshare Model.

Importantly, Performance Stock conversion could also result from raising more capital on favorable terms. It could come from a secondary public offering or a private offering.

Contrast these bad weather dynamics with those for a conventional capital structure. A VC may well have control over corporate governance matters as a result of how it negotiated its ownership stake. When it doesn't, it may have effective control via other means. Employee stock options? They don't vote. Employees are less likely to affect how problems and opportunities are evaluated and addressed. As a result, management may procrastinate or engage in top-down decisions, either of which can spawn dysfunction or reflect delusional thinking.

Negative energy is likely to seep into the environment because of the importance of the valuation in the last round. If events suggest that it was too high, wagons circle, blame is cast and factions form. By contrast, the energy in the Fairshare Model is focused on what will generate conversions—because it is forward-looking, it is more likely to channel positive energy. That's because valuation plays a far different role. A company with a conventional capital structure focuses on what needs to happen as well, but a lot of negative energy is bound to be released when some shareholders feel they were oversold, or feel that other shareholders are using the bad weather to extract advantage.

Essentially, the Fairshare Model recasts conventional ideas about corporate governance, giving employees a voice in governance. Is this a good idea?[137] Does it promote better capitalism? A more effective culture? Can a "strong-leader" operate effectively if employees have a say in corporate governance? Questions like these will be asked as interest in the Fairshare Model builds.

My sense is that giving employees a vote in corporate governance could be a positive influence for companies in any phase of development, start-up or mature, high growth or distress. Investors will gain a perspective on the company that is not controlled by the CEO. It can be of value to a CEO because employees are often a source or wisdom, and, getting their support can result in better solutions and more complete buy-in.

There will be much discussion about how voting rights should be distributed in the Fairshare Model. There will also be variation in how companies implement it. For example, some companies may have two classes of Performance Stock, one that votes and one that doesn't. In politics, comparable questions arose as feudal forms of rule were challenged. In England, the Magna Carta created the notion of a constitutional monarch—royalty required the consent of the governed (the lords, not the ordinary people). The formation of the United States of America radically transformed the relationship between those who govern and those who are governed. The French revolution had similar aspirations—*Liberty*, *Equality*, *Fraternity*—but their experiment descended into a morass that presaged, in some ways, the authoritarian mess that became known as communism more than a century later. Nations have conducted numerous "who can vote" experiments over time—companies that adopt the Fairshare Model will do the same.

Onward

This chapter concludes Section II, which began by examining a range of ideas about two macro-economic concerns that provide context for the Fairshare Model—economic growth and income inequality. It then considered how the ability to cooperate creates might offer diverse ways to address these twin challenges and how Fairshare Model promotes this. This chapter identified two structural elements that determine how a capital structure allocates uncertainty in an equity financing, something that will inform the discussion about economic growth, income inequality and equity crowdfunding. It also presented the most remarkable aspect of the Fairshare Model—it provides venture-stage companies a reason to offer public investors a low valuation. As a consequence, the model enables a well-performing team to create more wealth for themselves than if they use a conventional model and to create competitive advantage when it comes to managing human capital.

The tao of the Fairshare Model is clear—it is to balance the interests of entrepreneurial companies and public investors.

This section has been broad in content and philosophical perspective. Section III returns to a narrower micro-economic matter that come into play when venture-stage companies raise venture capital in a public offering—valuation.

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[137] In Europe, many companies give employees the right to appoint a member of the board of directors.

Section III: Valuation

Someone with long experience in crafting Hollywood stories and ads that engage people advised me to forgo my emphasis on valuation. He warned:

> *It's a snoozer! People want to engage at an emotional level.*
>
> *Just tell them the Fairshare Model will make them rich!*

Here's what he recommended I should do instead of writing about valuation:

> *Start with a story about a young couple who want financial security before they start a family. The husband has stock options, but his company can't raise the money it needs unless it has an IPO. It can't have an IPO because it's too expensive. As a result, his options are worthless.*
>
> *Because his options are worthless, he and his wife can't afford to have a baby.*
>
> *No IPO—no baby!*
>
> *Then say…the Fairshare Model can change that!!*

Man! Did he make me laugh![138] The pitch had nothing to do with the Fairshare Model. It relied on emotion and fuzzy association, not relevant issues.

But it was hilarious…he combined kitsch with insight into human nature. He knew that the best way to evoke interest in something is to *promote a positive outcome as the likely reward*. Ideas are boring to some people; they just want to hear that there will be a happy ending!

Dear Reader, because you are here, you clearly have interest in ideas. This section explores ideas about valuation in more depth, but not enough to be eye-glazing. It has four chapters:

- Chapter 12: Valuation Concepts
- Chapter 13: Calculating Valuation
- Chapter 14: Evaluating Valuation
- Chapter 15: Valuation Disclosure

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[138] The pitch reminds me of DirecTV commercials. The plot to one of them has a man is watching cable TV. He can't find anything he wants to see. He gets depressed and attends a motivational seminar that makes him feel like a winner. Feeling like a winner, he decides to go to Las Vegas. He loses his money and winds up sleeping on a bench. To get money, he pulls out his hair and sells it to a wig shop.

Now, imagine that visual sequence. With it in mind, the voiceover for the commercial will make sense:

When you have cable and can't find something good to watch, you get depressed.
When you get depressed, you attend seminars.
When you attend seminars, you feel like a winner.
When you feel like a winner, you go to Vegas.
When you go to Vegas, you lose everything.
And when you lose everything, you sell your hair to a wig shop.
Don't sell your hair to a wig shop.
Get rid of cable, and upgrade to DirecTV!

Chapter 12: Valuation Concepts

Preview

- Foreword
- Points to bear in mind
- What is the Value of an Idea?
- Startup Valuation Technology—Illustrated
- Valuation is a Challenge for Established Companies
- Valuation is a Challenge for Wall Street
- Valuation is a Challenge for VC and PE investors
- Valuation of Sustainable Companies
- What's the Micro-Economic Harm from Getting Valuation Wrong?
- What's the Macro-Economic Harm from Getting Valuation Wrong?
- Why is a Valuation Necessary?
- Onward

Foreword

How might one one think about valuation? How do the smartest guys in the room think about it? How might supporters of sustainable communities view the matter? What's the harm of getting it wrong? Why does a company need to have a valuation?

Points to bear in mind

1. Valuation is price; price is not necessarily worth.
2. A valuation may be seem reasonable in theory, but if no one is prepared pay that amount to buy the company outright, the value is speculative. Plus, what seems reasonable in a hot market looks untenable as it cools.
3. A company's valuation is set whenever shares of its stock are sold by the company or by shareholders.
    a. In a private offering where there is a lead investor, the valuation is set via a negotiation between that investor and the issuer. If there is no lead investor, it is set by the company—a take it or leave it proposition.
    b. In a brokered public offering, the valuation is determined by the broker-dealer and issuer.
    c. In a direct public offering (no broker-dealer), the valuation is set by the issuer.
    d. In an acquisition, the valuation is set by negotiation between the seller and buyer (the acquiring company.)

What is the Value of an Idea?

Entrepreneurs differ on how much time, thought and effort they have put into getting the idea ready-to-go without being (fairly) paid—the "sweat equity." Typically, the value of an early stage company rests heavily on an idea and its perceived potential. So, what is the value of an idea?

Entrepreneurs and their friends and family are most likely to have the highest assessment. Savvy investors, I think, will smile at Derek Sivers' thoughts on this subject, which are below. On his website (www.sivers.org) he says *"I'm a musician, programmer, writer, entrepreneur, and student — though not in that order. I'm fascinated with the usable psychology of self-improvement, communication, business, philosophy, and cross-cultural relativism. I love seeing a different point of view."*

IDEAS ARE JUST A MULTIPLIER OF EXECUTION

By Derik Sivers

It's so funny when I hear people being so protective of ideas. (People who want me to sign a Non-Disclosure Agreement to tell me the simplest idea.)

To me, ideas are worth nothing unless executed. They are just a multiplier. Execution is worth millions. Explanation:

Value of an Idea		
Awful Idea	=	*-1*
Weak Idea	=	*1*
So-So Idea	=	*5*
Good Idea	=	*10*
Great Idea	=	*15*
Brilliant Idea	=	*20*

Value of Execution		
No Execution	=	*$1*
Weak Execution	=	*$1,000*
So-So Execution	=	*$10,000*
Good Execution	=	*$100,000*
Great Execution	=	*$1,000,000*
Brilliant Execution	=	*$10,000,000*

To make a business, you need to multiply the two.

The most brilliant idea, with no execution, is worth $20.

The most brilliant idea takes great execution to be worth $20,000,000.

That's why I don't want to hear people's ideas.

I'm not interested until I see their execution.

Most people, I suspect, would agree with Sivers. But, bear in mind, **a conventional capital structure requires that a valuation be set on future performance** anytime an equity financing takes place.

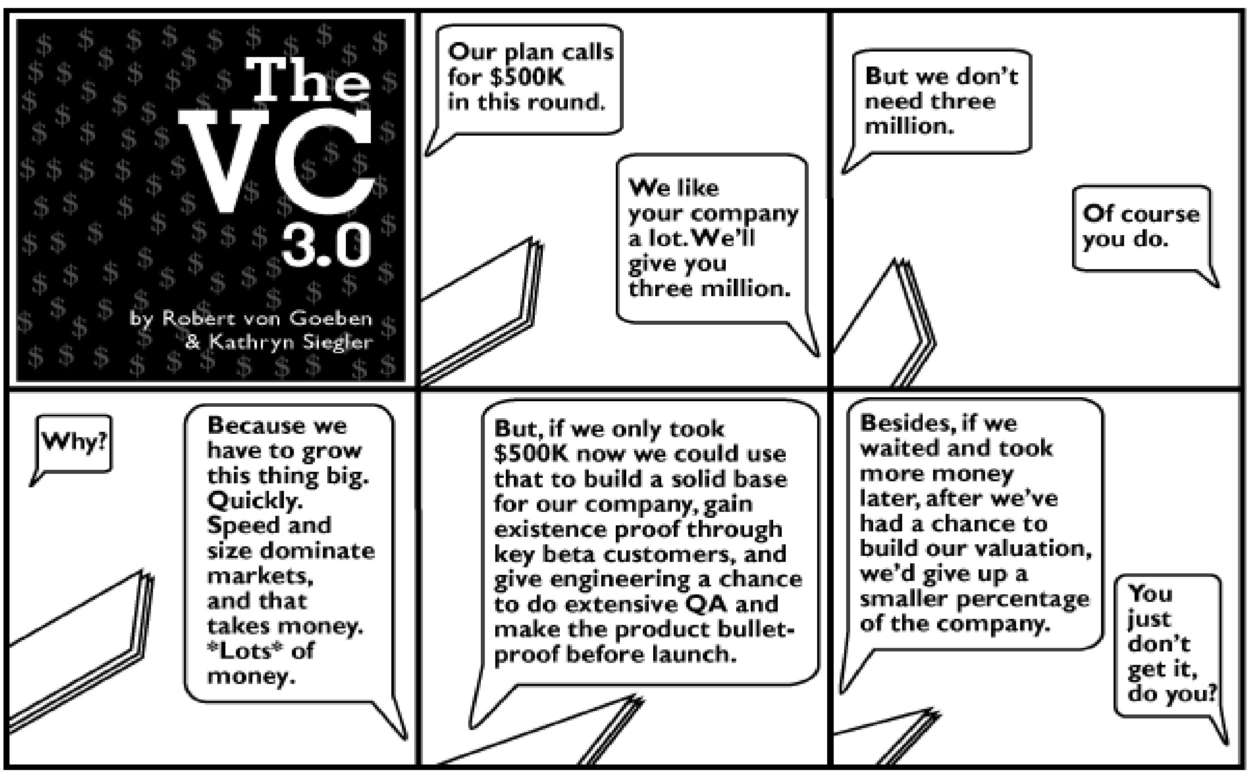
Can one reconcile his sentiment with a conventional capital structure? Sure! So long as it involves a private company; VCs routinely do it when they invest in a private company via deal terms. If it's a public offering to unaccredited investors, the answer is "no", which creates the opportunity, indeed, the need, for the Fairshare Model.

Startup Valuation Technology—Illustrated

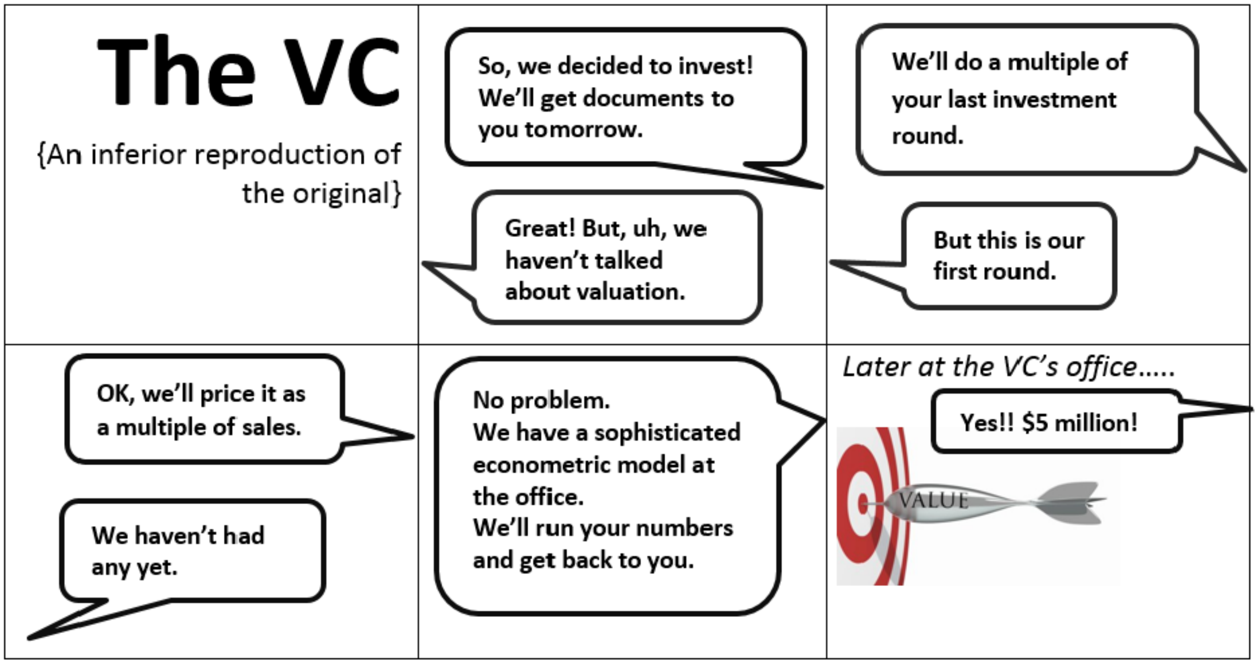
Time magazine annually selects a Person of the Year, the person who had the most significance impact that year. The first, in 1927, was Charles Lindbergh. In 1938, it was Adolf Hitler. Joseph Stalin made it twice, in 1939 and 1942. So did George Marshall, first in 1943 as U.S. Army Chief of Staff and then in 1947 as Secretary of State and progenitor of the Marshall Plan to rebuild war-torn Europe. In 1982, remarkably, Time broke its tradition by naming a non-person, the personal computer, Person of the Year. It signaled that technology was poised to powerfully alter everyday life, the economy and more.

In the 1980s, the technology boom that had taken root in the Santa Clara Valley area at the south of the San Francisco Bay inspired a name to capture the phenomenon, “Silicon Valley.” Publications sprang up that shed light on startup financing and culture. The emerging tech-cultural fusion created the ferment that allowed *Wired* magazine to launch in 1993. Less known nowadays is *Upside*, a magazine “for Silicon Valley about Silicon Valley” that started in 1989. That’s because it went upside down in 2002, a casualty of the precipitous drop in advertising revenue that followed the dotcom and telecom bust.

A regular feature in *Upside* was a cartoon strip called *The VC* that satirized issues related to the venture capital industry, which was growing rapidly. It was the creation of then-venture capitalist Robert von Goeben and artist Kathryn Siegler. They archive some of their strips at www.thevc.com. Here’s one to give you the flavor of its humor.



Remember, this was the dawn of the Internet Era. At the time, venture capitalists had concerns about mounting pre-money valuations for unproven companies that looked hot—they were moving from about $2 million to $5 million for a first round VC investment. The 2013 equivalent was $9.4 million.[139] *The VC* website does not have my favorite strip. It was on the subject of valuation, so, with apologies to von Goeben and Sieglar, I offer this version of what I remember.



The joke was that professional investors, these Masters of the Universe, really didn't have an objective way to evaluate valuation. Rules-of-thumb that had been applied for years by the old guard were being stretched by "new wave" VCs willing to accept valuations that were 2X higher or more. And, it was paying off for them because the IPO valuations were climbing on Wall Street.

Bill Reichert, managing director of Garage Technology Ventures tells the story about how he became a Silicon Valley software entrepreneur right out of graduate school in the 1980s. For reasons that mystified him at the time, VCs gave his team the capital they needed to launch a software company. It met with success and was eventually acquired. The same thing happened again. And then again. As an entrepreneur, he assumed that VCs had insight and techniques into how to value an early stage company. So, in the late 1990s, as he prepared to join their ranks by heading up Garage, he asked VCs he knew well, "What's the secret?"

He was told that the secret is that there is no secret. That VCs fund a deal because they fall in love. They fall in love with the company's market, its technology and its team. And, they feel, if they love the potential, others will come to love it too.

In other words, the valuation reflected emotion much more than a "sophisticated econometric model back at the office".

[139] "Startup valuations keep rising", Dan Primack, Fortune, Jan. 16, 2014, http://fortune.com/2014/01/16/startup-valuations-keep-rising/

Valuation is a Challenge for Established Companies

Chew on this. The book, *The Art of M&A* is a "joint effort of Stanley Foster Reed, the founder of Mergers & Acquisitions magazine and Lane Edison, a law firm well known for its merger, acquisition and leveraged buyout transactions."

The authors report that executives at established companies struggle with their valuation, relative to that of an enterprise they want to acquire, even though there is an abundance of reliable data to evaluate. They open their "Valuation and Pricing" chapter this way:

> *No factor counts more than price in closing a transaction. Yet very few operating executives have any notion as to how much their or anyone else's companies are worth except from the stock tables. Very few know how to go about answering that question when they buy or sell*.[140]

The Art of M&A is about legal and financial matters that arise in acquisitions of established companies, private and public. It's not about startups. But remember, a company's valuation for any round of financing is, presumptively, the price to buy the entire company. It's also the representation of worth that a company makes when it proposes terms for an investment. A single, large investor may well have a price in mind that is quite different from the valuation being offered to a group of smaller investors. Is it credible that anyone would pay the valuation price…now? If it is not—and incredible valuations are increasingly common—those who invest are less likely earn an attractive return. Whether a company is selling a slice of ownership or its entire self, valuation is important. And, if executives at large companies have a weak hold on valuation, it is unsurprising that others do as well.

An established company has years of revenue and earnings history. It has soft assets such as customers, a brand, know-how and other intellectual property that support products/services with demonstrated appeal. It has hard assets such as receivables, inventory and equipment. Taken as a whole, a due diligence review of this information will show where the company has been and provide a foundation for where it could go. An established company also has competitors who may value the company more highly than a financial investor because acquiring it allows them to add customers, reduce costs by consolidating operations, raise prices, etc.

A venture-stage company has few of these elements. Indeed, they often pursue new markets, so there is risk that the market for their product will not develop the way they expect or that competitors will outshine them. Whiz-bang technology can change the calculus, but only if the product is delivered in a timely way and is as impressive to customers as imagined. Compared to an established company, a venture stage company has a higher risk that its early customers will stop buying. Past success may be a poor predictor of future market demand.

If accomplished executives have difficulty assessing how to value a company with a developed business, you can expect that executives in venture-stage companies struggle even more to come up with a valuation for their start-up. You can also be sure that angel investors and professional investors have trouble too.

If you are less-than-confident about valuation issues, you have lots of company!

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[140], *The Art of M&A*, Stanley Foster Reed (1989), Richard D. Irwin, Inc. ,page 63

Valuation is a Challenge for Wall Street

How about companies that are not involved in an acquisition transaction? Is there an intrinsic value to a publicly traded stock? Finding an answer has been the Holy Grail of financial market theory development, the effort to credibly and consistently explain what is known or observed.

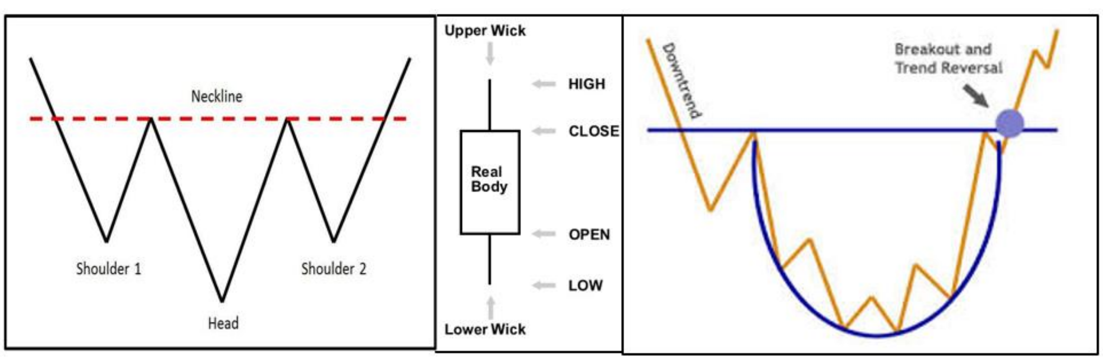
In his 1992 book, *Capital Ideas: The Improbable Origins of Modern Wall Street*, the late Peter L. Bernstein comprehensively examines the evolution of theories of how capital markets work. He says the idea of time value of money was well understood by the 1930s and that it led to the development of the dividend discount model as a way to evaluate the true value of a stock. The formula assumes that a stock's value come from its future dividend stream, discounted at a rate that reflects the time value of money and the risk associated with it. It is analytically sound. It is also intuitive that the value of an investment is derived from the income that it produces. The problem was that it doesn't explain prices

Columbia University's Benjamin Graham believed the difficulties of the Dividend Discount Model were insurmountable. [141] Although he believed that investors should base their decisions on the intrinsic value of a security, he felt it was "an elusive concept." In the seminal 1934 book *Security Analysis*, Graham and David Dodd used an analogy to suggest that **an approximate measure of intrinsic value was good enough**.

> *Graham and Dodd pointed out that "inspection [can reveal] whether a woman is old enough to vote without knowing her age, or that a man is heavier than he should be without knowing his exact weight." They defined intrinsic value as "that value justified by the facts, e.g., the assets, earnings, dividends, definite prospects."*[142]

To establish an approximate measure of intrinsic value, many rely on fundamental analysis—a review of financial statements and models. When an established company is evaluated, much attention is on what its financial statements show. However, when the subject is a venture-stage company, the focus is on the projections because historic financial statements yield little insight into future value. This is especially so when the company intends to create a new market or there is high risk. One can only hope that the projection model is well thought out, considers the key drivers to success, has prudent assumptions and no computational or logic errors.

Another way Wall Street assesses value is a form of gestalt known as technical analysis. It relies on trend charts to discern if the current stock price appears too high, too low or just right. Like readers of tea leaves, technical analysts look for "heads and shoulders", "candlesticks" and "cup and handles", etc.



[141] Graham is considered the father of "value investing" and his most famous student is billionaire Warren Buffet.
[142] Bernstein, Peter; Capital Ideas, Page 158

They also compare the price-earnings ratio to what it has been and to comparable companies. Technical analysis focuses on price trends, not the underlying worth of the asset.

As venture-stage valuations were fueled by the bull market of the 1990s, Wall Street analysts evaluated them based on a multiple of "eyeballs"—Internet users who visited a website. The ability to attract traffic meant that the stock was worth more, based on the presumption that revenue and profit would follow. This line of thought lead a leading analyst in the bubble to opine that dotcom valuations could be rationalized as a multiple of marketing expense. Internet companies that had the highest marketing expense should be valued higher than competitors that were not spending so aggressively.

So, keep a standard for intrinsic value in mind as we proceed. On the one hand, it makes sense that there is one. Theoretically, if market participants had equal access to information, knowledge and the skill to exercise it, there would be agreement on what it is—and—variation in price would be based on new information. On the other hand, it is apparently impossible to establish in reality because intrinsic value is derived from expectations about the future, which is difficult to get consensus on. Besides, no one has demonstrated the ability to be reliably right.

Thus, if one is *intent on building wealth* via the public capital markets, two paths present themselves. The bright path involves vision, the ability to assess risk well, hard work, discipline, luck and fortunate timing. No one gets this reliably right, so, diversification is prudent. And, one's ability maximize diversification within a portfolio of a set size is to buy in at an attractive valuation. The dark path, of course, relies on gamed systems, inside information, manipulation of perception, deception and/or cheating.

Valuation is a Challenge for VC and PE investors

Venture capitalists (and their cousins, private equity funds) are the savviest investors around when it comes to valuation of a venture stage company. They are smart, connected, focused and usually invest in market sectors that they have domain expertise in, including contacts to vet a company's concept, business model and management team. But, they have trouble with valuation too.

Nonetheless, a valuation must be set when there is an equity financing. VCs negotiate the lowest valuation they can without alienating the entrepreneurs that they want to attract. They will accept a higher-than-comfortable valuation in exchange for securing deal terms that protect their interests. Frankly, they rely more on the deal terms than the valuation to protect their interests. Put another way, to secure a deal, a VC will tell the entrepreneur "I'll give you your price if you give me my terms." In real estate, that expression reflects a way to bridge a valuation gap between buyer and seller. The buyer will agree to pay more than she feels the property is worth now provided that the seller offers to stretch out payments long enough to make that price acceptable. Such a deal minimizes the cash outlay the buyer must make when uncertainty is high about its future value. If the value doesn't rise enough, the buyer can walk away without losing much.

Some of the ways that economic deal terms can protect a VC from overpaying are:

1. If the company is sold, a *liquidation preference* entitles the VC to get a multiple of its investment back before other shareholders share in the proceeds;

2. An *anti-dilution clause* can retroactively adjust down the price paid by the VC if a subsequent investor buys in at a valuation that is lower than provided in the terms.

3. *Redemption rights* require a company to buy back the VC's investment in a few years if there isn't an investor exit. If the issuer can't, the equity investment can convert to debt, enabling the VC to "foreclose" on the assets. To avoid this, a company may offer the VC more shares at little or no cost.

4. *Conversion rights* can enable a share of the VC's preferred stock to convert into more than one share of common stock when the company has an IPO (i.e., the VC's ownership can increase without further investment).

In addition, the VC will seek terms related to corporate governance and control that enable it to "minimize risks, protect against any downside, and thereby amplify the upside."[143] Control of the board of directors enables the VC to replace management, set priorities and decide major business decisions.

The point is that as important as valuation is for any investor, VCs can give ground on it because they secure rights that retroactively reset the deal if the performance fails to meet expectations. For that reason, it is more accurate to say that they negotiate the *appearance of a valuation* when they invest, not the actual valuation.

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[143] Ramsinghani, Mahendra; "The Business of Venture Capital", John Wiley & Sons (2011), page 230

The illusory quality of a VC valuation is reported on in a March 2015 *Bloomberg* article titled *The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies: Startups achieve astronomical valuations in exchange for protecting new investors*, which is excerpted below. [Bold added for emphasis]

> *Snapchat, the photo-messaging app raising cash at a $15 billion valuation, probably isn't actually worth more than Clorox or Campbell Soup. So where did investors come up with that enormous headline number?*
>
> ***Here's the secret to how Silicon Valley calculates the value of its hottest companies: The numbers are sort of made-up**. For the most mature startups, investors agree to grant higher valuations, which help the companies with recruitment and building credibility, in exchange for guarantees that they'll get their money back first if the company goes public or sells. They can also negotiate to receive additional free shares if a subsequent round's valuation is less favorable. Interviews with more than a dozen founders, venture capitalists, and the attorneys who draw up investment contracts reveal t**he most common financial provisions used in private-market technology deals** today.*
>
> *The backroom agreements are becoming more common as tech companies stay private longer, according to the interviews and financial documents obtained by Bloomberg Business. The practice **obfuscates the meaning of a valuation, which can become dangerous down the road because private investors aren't taking the same risks a public-market shareholder would.***
>
> *Some VCs defend the practice by saying valuations are just a placeholder number, part of an equation fueled by other, more important factors. Those can include market share, growth projections, and a founder's ego. The number is typically set by the company and negotiated alongside various provisions designed to protect a new backer's money. That often comes at the expense of employee shareholders and earlier investors, whose holdings are diluted to make room for new entrants.*
>
> *"These big numbers almost don't matter," says Randy Komisar, a partner at venture firm Kleiner Perkins Caufield & Byers. "**Those numbers are just a middling shot at a valuation, and then it's adjusted later" through various legal techniques, if an earlier valuation was too high**, he says.*
>
> *A founder often starts off with a number in mind, based on the startup's last valuation, the valuations of competitors, and, for good measure, the valuation of the company's neighbor down the street. It can become a sort of arms race.*
>
> *Startups [have] all sorts of provisions [in their financing documents] that reward investors for accepting these mega-valuations. The practice is more regular and egregious in financing rounds for mature companies. Their capital requirements tend to be much larger, so they must turn to more sophisticated investment firms that demand these kinds of terms. Startups that are generous with these guarantees can garner much higher valuations.*[144]

[144] "The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies", by Sarah Frier and Eric Newcomer, Bloomberg, Mar. 17, 2015 http://bloom.bg/1wV4oE7

Valuation of Sustainable Companies

There is rising interest in a so-called sustainable economies and companies. There may not be a clear, practical definition of what constitutes a sustainable company, but it is clear that those that aspire to operate in this category rely on investors who are open to non-traditional perspectives on value. As a result, they will have a different perspective on valuation, one defined by a community of interests.

A middling shot at a valuation is likely to consider what the enterprise seeks to accomplish and how credible it is, not just its financial projections. The same can be said for companies with a mission that holds special appeal for other reasons. It could be one that focuses on a niche market, a particular geography, or a technology for special needs. It may involve soil conservation, medical devices, toll roads, products/services for schools, water treatment technology, movie projects or media companies that have doubtful commercial prospects.

Think about the types of enterprises that rely on philanthropy, grants and donations to provide the capital they need. If they tap into the equity markets—replace contributions with equity—they will face a valuation challenge too. The figure will reflect the value of the business and its mission.

Ideas about how to define and apply alternative measures of value are more developed than many recognize. For instance, the United Kingdom government has an impressive publication, *A Guide to Social Return on Investment (SROI)*, that explores how to determine a SROI for investors.[145] It identifies six stages to follow in order to establish a community-centric valuation:

1. Establishing scope and identifying stakeholders
2. Mapping outcomes
3. Evidencing outcomes and giving them a value
4. Establishing impact
5. Calculating the SROI
6. Reporting, using and embedding

The Fairshare Model holds promise for sustainable companies that want to raise capital using a public offering because it provides flexibility in defining value and performance.

The Seven Principles of Social Return on Investment

1. Involve stakeholders
2. Understand what changes
3. Value the things that matter
4. Only include what is material
5. Do not over-claim
6. Be transparent
7. Verify the result

Source: "A Guide to Social Return on Investment"

[145] http://www.bond.org.uk/data/files/Cabinet_office_A_guide_to_Social_Return_on_Investment.pdf

What's the Micro-Economic Harm from Getting Valuation Wrong?

So, valuation is important but it is hard to know what it should be, no matter if the company is established or a start-up. What is the harm of accepting one that is "too high?" From an investor perspective, clearly, it increases the likelihood that money will be lost or less will be made than could have been.

It is less obvious that entrepreneurs face challenges when they raise capital at an excessive valuation, as angel investor John Huston describes in a video on the angel investor site, Gust.

> *If I think back over the greatest ideas I've seen that have gone 'splat' and were never really brought to market, it's because they fumbled the funding plan.*
>
> *The most prevalent way they've done that is that they go out to raise the most money at the highest valuation and they take checks from 'mullet's', as we call them, who are just hobbyist angels who don't know what the current market valuation is, they don't know about terms and conditions. And if an inadequate amount of capital is raised to take out the risk to justify the valuation that they raised the money on.*
>
> *By definition, the next round (of capital) is a 'down round'. If you are an angel investor who sees a deal or two a day, why would you look at a down round?*

A down round occurs when a company raises capital at a lower valuation than the prior one (i.e., it was overvalued earlier or failed to perform as expected). When that happens, a company loses its shine in the eyes of its shareholders. The expectancy that management is capable diminishes, a perception that seeps into how new investors view the latest projections. Stock option plans may get re-priced, fostering a sense that employees can benefit where early investors cannot. Rumors of weakness will float in the community.

The term "down round" is associated with a private company. Earlier investors don't have the ability to sell their shares, so they are effectively strapped in for the ride. I suppose it could apply to a public company—one that raises new capital at less than the IPO valuation. But in a public company, investors can sell when they want to get off the ride.

Regardless of whether a company is private or public, Huston's point applies: a business that otherwise has an upside introduces a downside when either the company or its investors are not valuation aware and savvy.

> *We don't know if we're investors until the exit occurs–until then we're merely donors.*
>
> -- John Huston, founder of Ohio Tech Angels, speaking at the 2013 Angel Capital Association Summit in San Francisco, CA

What's the Macro-Economic Harm from Getting Valuation Wrong?

There is a broader harm that comes from valuation unawareness—it fuels asset valuation bubbles that wreak havoc. There is a long history of these occurring, as explained in the PBS *Nova* program, *Mind Over Money; Can markets be rational when humans aren't?* Here is an excerpt from the program.[146]

> *The first financial bubble involved something highly unlikely.*
>
> *JUSTIN FOX (Harvard Business Review): In the 1630s, in the Netherlands, people were buying and selling Tulip bulbs...complete, mass insanity in Holland, for a couple of years there, where hundreds of people, artisans, would leave their workshops and set up business as "florists," they called themselves, although, for the most part, what they really were were tulip bulb traders. And it was a real financial market.*
>
> *ROBERT SHILLER (Yale University): The price of tulips in Holland rose to such a level that the value of one tulip bulb would sometimes be that of an entire house.*
>
> *NARRATOR: Over a three-year period, the price of tulip bulbs rose and rose, and then began to soar. By some accounts, almost half of all the money in the Dutch economy was caught up in trades involving tulips.*
>
> *JUSTIN FOX: To a lot of historians, this is really the first example of a financial bubble, even though it was, basically, tulips.*
>
> *ROBERT SHILLER: People were buying them, not primarily because they liked tulips, but they were buying them because they thought that the price was going up and they could resell them to someone else at a higher price.*
>
> *NARRATOR: On February 5, 1637, the most expensive bulb in Holland failed to sell, and tulip investors panicked.*
>
> *ROBERT SHILLER: Then it burst, because prices start falling. And then they're falling more, and then you start thinking, "You know, I remember I doubted that tulips could possibly be worth so much. Maybe I better get out fast." And then everyone starts dumping, and then it just drops.*
>
> *NARRATOR: As the prices plunged, leading citizens found themselves bankrupt. Some historians estimate it took a generation for the Dutch economy to recover. There have been many bubbles and crashes since, but the most famous happened closer to home.*
>
> *The year 1929 began with optimism. Stock prices had been rising for eight years, and in '29 they were soaring.*
>
> *JUSTIN FOX: The 1920s was a great decade economically. The economy was booming, industry was booming, and toward the latter part of the decade, financial markets just sort of went from reflecting that boom to, kind of, creating it. It was just boom times all over. By the late 1920s, there was just this feeling of a new era.*
>
> *NARRATOR: Observers described feverish emotions, as thousands of investors paid ever-higher prices for stocks.*

[146] http://www.pbs.org/wgbh/nova/body/mind-over-money.html

ROBERT SHILLER: In the so-called "roaring '20s" the stock market went through an enormous bubble; people thought it would never end.

NARRATOR: But then, on October 29th, prices suddenly dropped, and the mood turned to one of panic and fear. Over 9,000 American banks failed, wiping out the life savings of millions.

ROBERT SHILLER: It led to a depression that lasted over 10 years.

More recently, there was the dotcom and telecom bubbles that burst in 1999-2000. Technology promised to transform many facets of life. Investors saw young companies coming into the stock market that had questionable prospects…and they went up in price anyway. The accelerant was that many public investors were unfamiliar with valuation and how to evaluate it.

Now, valuation awareness does not, in and of itself, prevent bubbles. Investors may be valuation aware but be unsure about how the evaluate a valuation. Or, they may decide that FOMO—*Fear Of Missing Out*—trumps prudence. When enough people share this sense, bubbles grow, until they bust. It's a cycle we've seen for generations in securities and real estate.

Cheerleaders are the handmaidens of bubbles because they conjure up ways to rationalize bubbles. During the 1990s the number of visitors or "eyeballs" a website attracted drove valuations. Highly regarded Wall Street analysts argued that companies that spent the most on marketing should be the more highly valued. It was crazy idea but one that explained what was happening in the market. At the time, the CEO at a small public company told me that he expected to attract investors at a high valuation by showing he would spend heavily on marketing—he was later fired.

Valuations of venture-backed startups are blossoming nowadays and cheerleaders are evident again. For example, in an August 2014 opinion article in the *Wall Street Journal*, the CEO of a business valuation firm asserts that:[147]

- *The majority of startups and small businesses are not overvalued.*
- *It is the startups that create new markets that can ask for larger premiums.*
- *We should do more to create new companies and not worry as much if the companies being created are overvalued or not. As a country, we should focus on helping them have better knowledge and access to capital.*

Tellingly, this view is advanced by someone positioned to profit from rising valuations…a firm that charges companies to opine on what they are worth. The arguments made about eyeballs or marketing expense were made by analysts affiliated with the underwriters of the companies they rationalized high value for.

Strikingly, future performance is both presumed and deemed valuable enough to command a premium. Why? Because no one has done it before!

More provocative is the argument that we should not worry about whether companies are overvalued. Opposing perspectives come to mind when I contemplate this. On the positive side, an

[147] "A Look At Startup Valuations Now and Then" by Michael Carter, Wall Street Journal, Aug. 29, 2014, http://blogs.wsj.com/accelerators/2014/08/29/michael-carter-a-look-at-startup-valuations-then-and-now/

entrepreneurial culture thrives when capital is available on attractive terms and such a culture feeds an innovative economy. So, yes, we need to improve access to capital, as the writer suggest. On the negative side, yikes! Do we not learn from history? Are we destined to relive boom bust cycles?

Economist Hyman Minsky considered this question and concluded that financial markets are inherently vulnerable to them. Early in 2008, before the downturn was called the Great Recession, *The New Yorker* summarized Minsky's financial-instability hypothesis this way:[148]

> [In the early 1980s,] *when most economists were extolling the virtues of financial deregulation and innovation, a maverick named Hyman P. Minsky maintained a more negative view of Wall Street; in fact, he noted that bankers, traders, and other financiers periodically played the role of arsonists, setting the entire economy ablaze. Wall Street encouraged businesses and individuals to take on too much risk, he believed, generating ruinous boom-and-bust cycles.*
>
> *Many of Minsky's colleagues regarded his "financial-instability hypothesis," which he first developed in the nineteen-sixties, as radical, if not crackpot. There are basically five stages in Minsky's model of the credit cycle: displacement, boom, euphoria, profit taking, and panic. A displacement occurs when investors get excited about something—an invention, such as the Internet, or a war, or an abrupt change of economic policy.*
>
> *As a boom leads to euphoria, Minsky said, banks and other commercial lenders extend credit to ever more dubious borrowers, often creating new financial instruments to do the job. During the nineteen-eighties, junk bonds played that role. More recently, it was the securitization of mortgages, which enabled banks to provide home loans without worrying if they would ever be repaid. Then, at the top of the market, some smart traders start to cash in their profits. The onset of panic is usually heralded by a dramatic effect.*

Stock manias could be included in the article. Contrary to what the CEO wrote in his WSJ Op-Ed piece, there is reason to believe that venture-stage companies are overvalued, and, that the combination of cheerleaders, a lack of valuation savvy and FOMO are a recipe for a boom bust cycle.

This tempers my enthusiasm for equity crowdfunding. I'm not bothered that investors will lose money, I bothered that they will lack the ability to make bets that have a reasonable chance of paying off. I look at venture stage investing as a game of roulette. The more numbers you place bets on, the more likely it is that you will have a winner. It is easy to lose one's head when betting; one is less likely to lose it when the chips are inexpensive (i.e., valuations are low).

Simply put, the overall harm of getting valuation wrong is that it encourages speculation that leads to boom bust cycles, something that is bad for an economy. Speculation that supports adventurism—more bets on the table—is desirable because it supports innovation. The trick is to simultaneously encourage adventurism and realistic valuations.

I am enthusiastic about equity crowdfunding provided that public investors have the opportunity to get the type of deal a VC gets.

> Start-up Sprinklr Says Its $1.2 Billion Valuation in New Round is 'Conservative'
>
> --WSJ, April 3, 2015

[148] http://www.newyorker.com/magazine/2008/02/04/the-minsky-moment

Why is a Valuation Necessary?

Why is it necessary to set a valuation? Why can't people just provide the money a company it needs and compensate employees for doing a good job? Such questions may come to mind to readers who are unfamiliar with capital structures.

The answer rests on what the people want in exchange providing the organization with the capital it needs to operate. If they want an ownership interest, a valuation is needed to establish what it is relative to earlier providers of capital and to those who provide ideas and labor. If no ownership interest is required, the organization will simply ask those providing the capital for a donation. If it is registered as a not-for-profit company with the Internal Revenue Service, those who donate can write off the contribution from their taxable income in the year they send the money. If it is registered as a for-profit company with the IRS, those who provide the money must wait until they sell their ownership at a loss or the entity liquidates to write off their "contribution."

An ownership interest enables contributors of resources to have something to sell to others. Without one, as just noted, they are merely donors!

The ownership interests in the Fairshare Model have a valuation, however, it provides incentive for those who contribute ideas and labor to offer a low valuation because the price of future performance is separated from price of the capital raised to support it.

Thus, the Fairshare Model answers the question "Why is it necessary to set a valuation?" by decoupling the value for delivered performance from the value of future performance. Essentially, the providers of unproven ideas and undelivered labor say to the providers of capital "We don't know what the value of our prospects are, so we are willing to defer the matter until we deliver performance provided we feel assured that we will be appropriately rewarded."

Onward

Valuation is something that the smartest people in the room have trouble with, regardless of whether a company is a start-up or established. For this reason, Dear Reader, even though you may be a complete novice on valuation, there are two questions you can ask of anyone who is raising money for a company that will make you appear astute on the subject. The first is "what is the valuation?" and the second is "why does that make sense?"

Venture-stage companies are particularly difficult to value. Nonetheless, the beast otherwise known as a conventional capital structure demands a valuation of future performance. The Fairshare Model renders this issue unimportant. The question for financial professionals is, how will valuation theory change if the villagers—entrepreneurs and investors—realize that they don't have to feed the beast?

With these concepts in mind, we move onto how to calculate the valuation that a company has given itself.

Chapter 13: Calculating Valuation

Preview

- Foreword
- Pre-Money vs. Post-Money Valuation
- Calculating valuation – share method
- Calculating valuation – percentage method
- Valuation is not intuitive
- Price per share is not valuation
- Valuation -- Primary and Fully Diluted Shares
- Valuation Calculation Using the Fairshare Model
- Onward

Foreword

There a variety of ways that companies decide how and where to set their valuation. This chapter explains how to calculate it.

Pre-Money vs. Post-Money Valuation

"Valuation" is a slippery word because it can be understood to mean something different, depending on the context. The last chapter opened with some points to keep in mind when contemplating valuation issues. The most important one is that valuation is price, and that price is not necessarily worth. That's an idea that makes sense even if you don't know how to calculate the valuation.

If you are going to calculate or evaluate a valuation, it is similarly important to be mindful of the difference between a company's pre-money and post-money valuation. The difference is the money—the total investment. But there is also a difference in relevance—the pre-money valuation is the one that is important when money is being raised.

To help make the distinction between pre-money and post-money valuation clear, imagine a pair of pants offered for $20. You put $10 in the pants pocket. What is the value of the pants?

	Value
Price of the pants	$ 20
Money that you put in the pants pocket	10
Value of pants with your money	$ 30

The first thing that you ask yourself is "When?" Before or after you put your money in the pocket? The $20 price is the analog of "pre-money valuation." The $10 that you put in the pocket is the "money" and the $30 is the "post-money valuation."

The pants are worth $30 after your $10 is in the pocket. That is, *if the pants are worth $20 to begin with.* If the pants are worth $15 before the money, they are worth $25 now. If the pants are worth $25 before the money, they are worth $35 now.

Clearly then, the answer to the question-- What is the value of the pair of pants?—depends on the context. Before or after the money? Just as clearly, the **most important figure is the pre-money valuation**—what the pants were worth before you put your money in the pocket. That is true for companies too.

With this metaphor in mind, let's return to the example in chapter eleven, *The Tao of the Fairshare Model*. We have a company that raises *$5 million* from investors in exchange *for half the company*. The parties agree that the issuer's pre-money valuation is $5 million. The table below summarizes the deal. The post-money valuation of $10 million is equivalent to the value of the pants with your money. As with the pants, the figure to focus on the pre-money valuation—is the company worth that before the money is invested?

	Valuation	Ownership
Pre-Money Valuation (Employees)	$ 5 million	50%
Money (New investors)	5 million	50%
Post-Money Valuation (Combined)	$10 million	100%

This chapter answers the question "How does one calculate the pre-money valuation?" Or, in the example, "How can you tell that the pre-money valuation is $5 million?" It makes no judgment about whether it is high, low or just right.

Determining *what the pre-money valuation is* a simple, mechanical process. All you need a formula, a calculator and a few moments. Determining "*what the pre-money valuation should be"* is a complex matter; the next chapter discusses that.

There are two methods to calculate it—using the number of shares outstanding or percentage of the ownership offered.

Calculating valuation – share method

Here's the formula to calculate the pre-money valuation using the outstanding shares method.

Pre-Money Valuation	=	Number of Shares Outstanding Before the Offering	X	Price of a New Share

If a company has 10 million shares outstanding before an offering and plans to sell new shares for $1.00, its pre-money valuation is $10 million. It doesn't matter how many shares it plans to sell, its pre-money valuation is $10 million. All that matters is how many shares are outstanding and the price of a new share.

Why a share is worth $1.00 is a more philosophic question. So is the question "Why are there 10 million shares already outstanding?"

Let's apply this formula to a fresh example. ABC Company has 10 million shares outstanding and plans to raise $5 million. To do so, it decides to issue 1 million new shares at $5.00 per share. With these terms, ABC gives itself a $50 million valuation (e.g., 10 million shares outstanding X $5.00).

ABC Company's Pre-Money Valuation Using Share Method

ABC's Pre-Money Valuation	=	Number of Shares Outstanding Before the Offering	X	Price of a New Share
$50 Million	=	10 Million shares	X	$5.00 per share

Here is the relationship between ABC's pre-money and post-money valuation.

ABC Company's Pre- and Post Money Valuation

$ 50 million	Pre-money valuation (10 million shares X $5.00 per share)
+ 5 million	Money raised in the offering (1 million shares X $5.00 per share)
$ 55 million	Post-money valuation (11 million shares X $5.00 per share)

After the offering, if someone sells a share of ABC stock for $6.00, or $1.00 higher than the offering price, the company's valuation—its market capitalization—will rise from $55 million to $66 million (11 million shares X $6.00).

Conversely, if the most recent share price is $4.00, ABC's valuation falls to $44 million (11 million shares X $4.00).

Whether ABC is privately held or publicly traded, the calculation assumes that stock is sold at market value, and, that the latest price is the value of each share outstanding. Theoretically, it is what someone would pay to buy the entire company.

Calculating valuation – percentage method

You can also calculate the pre-money valuation if you know the percentage of the company that an amount of money buys. The formula is:

$$\text{Pre-Money Valuation} = \left(\frac{\text{Investment Amount}}{\text{Percentage of the Company Bought}} \right) - \text{Investment Amount}$$

As you'll see in a moment, it is nothing more than a variation of the simple formula you've seen. Stepwise, first calculate the post-money valuation. That is what you get by dividing the investment amount by the percentage of the company.

$$\text{Post-Money Valuation} = \frac{\text{Investment Amount}}{\text{Percentage of the Company Bought}}$$

Next, subtract the investment amount to get the pre-money valuation.

Let's apply this to an example. Say that 10% of XYZ Company is offered for $10 million. What is the pre-money valuation? First, calculate the the post-money valuation, so, divide $10 million by 10%.

$$\$100{,}000{,}000 \text{ [XYZ's post-money valuation]} = \frac{\$10{,}000{,}000 \text{ investment}}{0.010 \text{ [10\% of XYZ)}}$$

The result is a post-money valuation of $100 million. The second step is to subtract the amount of the new investment from the post-money valuation. That is the pre-money valuation.

$$\text{Post-Money Valuation} - \text{Investment Amount (Money)} = \text{Pre-Money Valuation}$$

For XYZ's, subtract the $10 million investment from the $100 million post-money valuation. The result is XYZ's pre-money valuation, which is $90 million.

$$\underset{\text{[XYZ's post-money valuation]}}{\$100{,}000{,}000} - \underset{\text{investment}}{\$10{,}000{,}000} = \underset{\text{[XYZ's pre-money valuation]}}{\$90{,}000{,}000}$$

You can tell this is correct because $10 million buys 10% of the company; $10 million is 10% of the $100 million post-money valuation.

XYZ Company	Valuation	Ownership
Pre-Money Valuation	$ 90 million	90%
Money	10 million	10%
Post-Money Valuation	$ 100 million	100%

Valuation is not intuitive

Unless you are a math whiz, you'll probably need a calculator to compute valuation, particularly using the percentage method. If you think you can eyeball it, be careful. To see why, let's examine how the pre-money valuation changes as the percentage of ownership by new investors changes.

The table below shows how valuation has a non-linear relationship with a percentage of the compnay being bought. It shows the valuation range of XYZ Company, the one we just calculated the $90 million pre-money valuation for, given that $10 million buys 10 percent of the company. The table shows the pre-money valuation at mulitple points, ranging from 1 to 100 percent, assuming the amount raised is $10 million.

On the far left, it shows that if 1 percent of the company sold for $10 million, its pre-money valuation is $990 million and its post-money valuation is $1 billion (or $1,000 million). On the far right, it shows that if 100 perscent of the company sold for $10 million, its pre-money valuation is zero. Between those two columns are valuations for various percentages of ownership—the invesment amount is fixed.

Valuation is Non-Linear

Assume Investment is $10 Million.

As the Percentage of Company the Investment Buys Climbs Note How Pre-Money Valuation Falls

Percentage of Company	**1%**	**10%**	**20%**	**30%**	**40%**	**50%**	**60%**	**70%**	**80%**	**90%**	**100%**
Pre-Money Valuation	**$990M**	**$90M**	**$40M**	**$23M**	**$15M**	**$10M**	**$7M**	**$4M**	**$3M**	**$1M**	**$0M**
+ Money Investment	$10M	$10M	$10M	$10M	$10M	$10M	$10M	$10M	$10M	$10M	$10M
= Post-Money Valuation	$1,000M	$100M	$50M	$33M	$25M	$20M	$17M	$14M	$13M	$11M	$10M

Look at the column where 10 percent of the company is sold for $10 million—the pre-money valuation is $90 million and the post-money valuation is $100 million, just as calculated on the last page.

The next column has the valuation when the percentage purchased doubles, from 10 to 20 precent. Notice that the pre-money valuation changes disproportionately. It goes from $90 million to $40 million (i.e., it is not half of $90 million).

Now double the percentage pruchased again—go to the column where the percentage purchased is 40 percent and compare it to the 20 percent column. The change in pre-money valuation is again disproportionate, it goes from $40 million to $15 million.

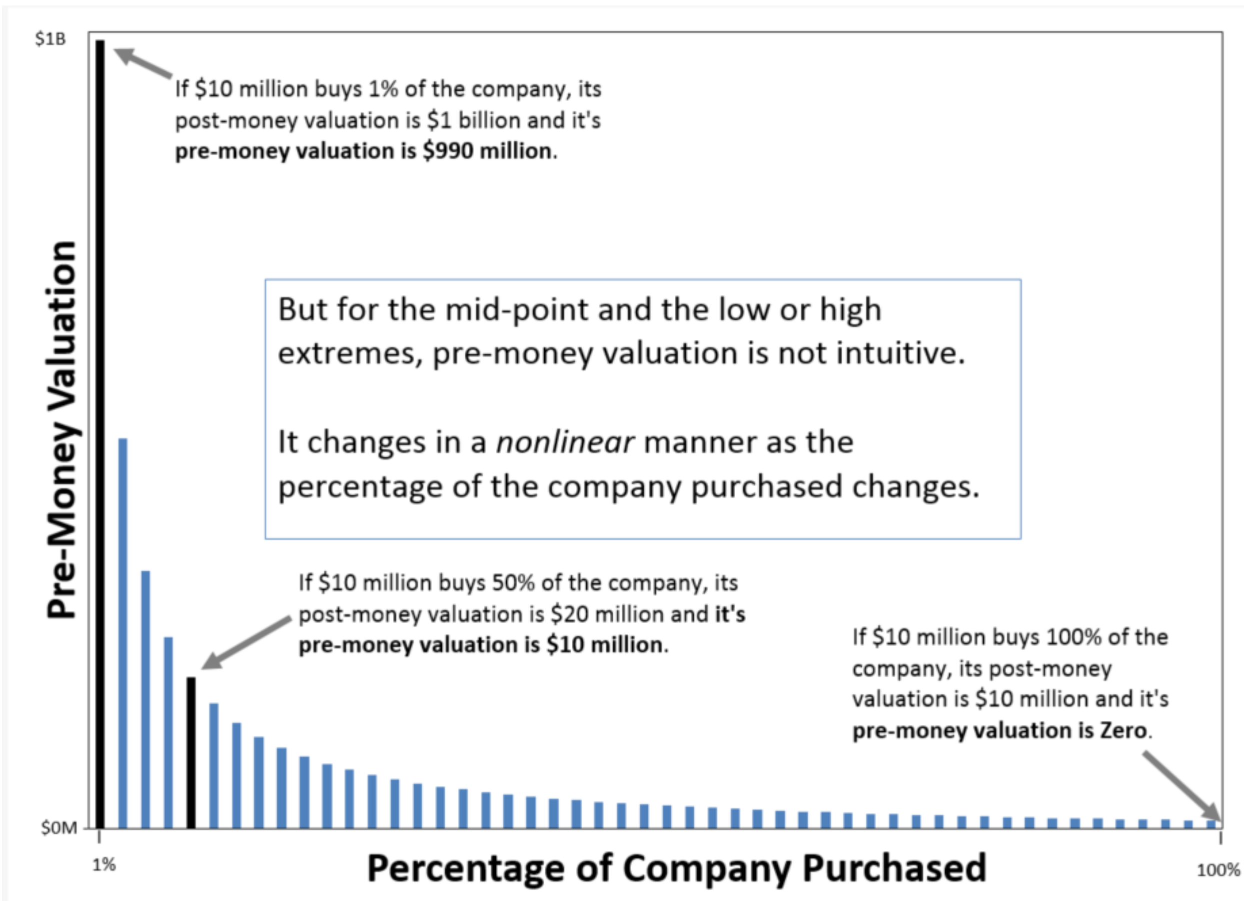
Do it again. Double the percentage of the company purchased for $10 million from 40 percent to 80 percent. Note that the pre-money-valuation drops disproportionately, from $15 million to $3 million.

Could you calculate these pre-money valuations in your head? Would you, if you were evaluating a deal? Most people would want a calculator.

Appendix A at the end of the book has a set of tables show the pre-money valuation for a range of investment amounts and percentage of the company purchased. You may find it interesting to scan how a change in one variable affects the pre-money valuation.

A takeaway point from the tables in Appendix A is that when half a company is for sale, the pre-money valuation is always the same amount as the amount raised. That is, if half the company is sold for $5 million, the pre-money valuation is $5 million. If half is sold for $20 million, the pre-money valaution is $20 million. If half is sold for $30 million, the pre-money valuation is $30 million and so on.

Another takeaway is, for the most part, valuation is not intuitive—it needs to be calculated. Visually, this becomes clear from the chart below. It illustrates the non-linear relationship between the pre-money valuation and the percentage of the company sold for a given investment amount.



The chart above assumes the investment amount is $10 million. On the low end, if it buys 1 percent of the company, the post-money valaution is $1 billion and the pre-money valuation is $990 million. On the high end, If it buys the entire company, the post-money valuation is $10 million and the pre-money valuation is zero. If it buys half the company, the post-money valuation is $20 million and the pre-money valuation is $10 million, the same as the investment.

The curve is exactly the same regardless of the amount of the investment.

Price per share is not valuation

So, valuation reflects the number of shares outstanding and the share price. What that means is that an increase in the number of shares outstanding will increase the valuation unless the share price drops enough.

I suspect that many investors who buy publically traded stocks don't pay attention to market capitalization. Instead, they decide whether to buy or sell based on what the price per share is. Stock price behavior after a stock split suggests this is true. A two for one stock split, for example, gives shareholders two shares of stock for every one they have. If markets were rational, the post-split stock would trade at half pre-split price; after all, it's the same company with twice the number of shares. When companies do split their stock, however, its not unusual to see the stock price move up. Why? Investors who are valaution unaware bid the price up.

IPO pricing provides additional evidence that retail investors focus on the share price, not the valuation. Ever notice how IPO prices tend to fall within a range of $14 to $18 per share? It's subtle marketing. The psychology is similar to what happens in other forms of retailing. Items priced at $19.95 move better than those priced at $20.00 or $20.10. Cars sell better at $19,900 than at $20,000. This propensity of consumers to round down and of retailers to create psychological "hooks" has been studied for decades.[149]

Razzle-dazzle elements infuse most forms of marketing. When an item has utility like a car, travel, food, or a pair of pants, buyers are better able to distinguish value from price, but razzle dazzle is nonetheless effective at persuading them to pay more.

When the item marketed is an investment—something without utility—buyers are far more likely to focus of things that may not be as important, like price per share.

[149] In his 1957 book, *The Hidden Persuaders*, Vance Packard, compared the use of motivational research and other psychological techniques to ''the chilling world of George Orwell and his Big Brother.'' http://www.nytimes.com/1996/12/13/arts/vance-packard-82-challenger-of-consumerism-dies.html

Valuation -- Primary and Fully Diluted Shares

Valuation calculations focus on shares that have been issued and are outstanding. A complication is introduced when a company has committed to issue shares in the future under certain circumstances. For example, the company have given investors who have lent the company money the right to convert the debt owned to stock at a pre-set price (i.e., convertible promissory notes). More commonly, stock options and warrants have been issued that result in new shares being issued at a pre-set price if and when the right to do so is exercised.

These are examples of "contingently issuable" shares or share equivalents—stock that is not outstanding but can reasonably be construed to be. When accountants report a company's earnings per share, they have two measures, "primary" and "fully-diluted".[150] Primary EPS is the earnings for the period divided by the average number of shares outstanding during that period. Fully diluted EPS is the same calculation except that the denominator also includes unissued shares that meet criteria for being "contingently issuable."

There is no uniform answer for how to deal with contingently issuable shares when calculating valuation. When VCs assess a company's pre-money valuation, some, but not all, include a new employee stock option pool in the shares outstanding even when the option plan doesn't exist yet, and it will take years for shares to be issued. When this occurs, the new investors (the "money") effectively says to the existing shareholders "all dilution that will result from the option plan to motivate employees must come out of your share of ownership." By contrast, market makers and professional investors for traded stocks focus on the relationship between the issued shares and shares that are available to trade, the "float." They tend to ignore unissued shares and issued shares that will not affect the trading market in the near term.

The issue of contingently issuable securities is beyond the scope of this book, which is to provoke support for the Fairshare Model. However, this will be a topic of discussion for entrepreneurs and those involved in financial reporting and services…once they see that there is significant investor interest in the model.

[150] "As converted" is a scenario for defining outstanding shares when there is debt that could convert to shares, but hasn't. Typically, investors assess private companies on this basis as well; it falls between actual shares outstanding and full-diluted shares. It's unlikely to be relevant in the Fairshare Model; pre-IPO investors will most certainly prefer to convert their debt to tradable Investor Stock.

Valuation Calculation Using the Fairshare Model

In the Fairshare Model, a very large block of Performance Stock is outstanding at the IPO. For example, if one million shares of Investor Stock is outstanding after the IPO, there could be ten or twenty million shares of Performance Stock. The reason there is a high ratio of Performance Stock is that it is intended to motivate performance for years—possibly a decade—and it may be harder for legal, tax or accounting reasons to issue new Performance Stock after a company is public.

The sheer number of shares of Performance stock is not important. Regarding voting rights, Performance Stock is capped at 50 percent of the vote (or whatever is proscribed in an issuer's incorporation documents). Regarding dilution of Investor Stock, what matters is the conversion rules. On this last point, think of a dam. From the perspective of the town downstream from the dam—the Investor Stock in this analogy—it doesn't matter how much water is behind the dam, which represents the Performance Stock. What matters is the release rate of the water.

How much of the Performance Stock will convert? That depends on the company's performance and the rules established by the Investor and Performance Stock shareholders. Broadly speaking, it seems likely that some will convert, but there is no reason to assume that all of it will. And of course, the further out one looks, the harder it is to project what the performance will be and what the market value of the company will be, both as a result of the performance and any conversions that occur.

When calculating pre-money valuation, I believe that Performance Stock should be excluded from the basic valuation calculation based on primary or issued shares because they can never trade and any liquidation preference that it has is of *de minimis* or trivial value. Should they be considered in a fully-diluted style valuation calculation? Probably, but it makes sense to estimate the enterprise value that might result from the anticipated performance.

This is a complex topic. I've thought about it lightly and there are several angles to this subject. Expert opinions may vary and I look forward to dialogue on it.

How should such shares affect the valuation calculation? If a company has a stock option plan for employees, has issued warrants to purchase stock or has debt that could convert into shares, they can affect how valuation is calculated.

The question is arcane to the target audience for this book, most of whom are valuation unaware. And, I don't think they care.

What they care about, I believe, is how to make it possible for…*Middle Class investors to make venture capital investments on terms comparable to those that professional investors get***.**

That's the prize that all eyes should be set on.

Onward

If you know a company's valuation, how do you evaluate it? How do you identify what is reasonable? What's a deal? What's out of line?

Chapter 14: Evaluating Valuation

Preview

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- It's in the Eye of the Beholder
- The Next Guy Theory tells you all you need to know
- Is there an intrinsic value?
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Foreword

To get a sense of whether stock market valuations are attractive overall, Warren Buffett, the world's most famous investor, compares the value of a country's stock market to its annual economic output. If the stock market value exceeds 100 percent of the GDP, he feels the market overvalued. If it is less than 50 percent, it is undervalued. He said "It is probably the best single measure of where valuations stand at any given moment."[151]

Buffett is not a venture-stage investor—he favors companies with established business. But how might a savvy investor evaluate the valuation on a company that relies on investor money to exist? Goldilocks could evaluate whether bowls of porridge was too hot, too cold or just right, but how might such an investor assess whether the valuation a company gives itself is high, low or just right? company? Or, that it is a wee bit over the right price of $9.5 million? If there has been no performance yet—it is worth anything at all?

This chapter provides an overview of the approaches to assess a valuation.

[151] http://www.businessinsider.com/buffett-valuation-says-stocks-overvalued-2015-8#ixzz3jCDVLaAg

It's in the Eye of the Beholder

Value, like art, is a concept, especially if the object has little utility. It is more in the eye of the beholder than an objective measure. In addressing **the difference between price and value**, Peter Bernstein, author of *Capital Ideas,* put it the following way [bold added for emphasis]: [152]

> *From Adam Smith, the eighteenth century author of The Wealth of Nations, all the great economists have wrestled with this problem in one form or another; it plays a central role in Karl Marx's model of capitalism.*
>
> *Economists agree that "value" refers to something that lies behind, or beneath, the prices observed in the marketplace; prices gyrate around "true value". But what is "true value"?*
>
> *The question is not unlike the exchange between three baseball umpires trying to describe how they distinguish between a ball and a strike. "I call them as I see them", said the first. "I call them as they are", replied the second. "They ain't nothing till I call them", declared the third.*
>
> ***Is value a subjective quantity? Or is it a quality that cannot be measured except by some objective standard? Or does value emerge only when a transaction takes place in which buyers and sellers agree on a price?***
>
> *The reason stock prices jump around so much, and the reason stocks are considered such a risky investment, is that there is nothing clear-cut about their value. Is GM worth $50 a share because the accountants, in their wisdom, add up GM's assets, deduct its liabilities and find that the difference is $50? Or is worth only $40 because a security analyst applying the [Discounted Cash Flow] model finds $40 to be the discounted present value of GM's future cash flows? Or is it worth perhaps $60 because there is a rumor that the hot mutual fund manager or the latest takeover artist is buying it, and everyone knows that what they buy is bound to go higher?*
>
> *The most pessimistic and disturbing, and the most amusing answer to these questions came from [economist John Maynard] Keynes, who was no mean speculator in his own right. Published in 1936, Keynes' sarcastic indictment of the stock market appears in a chapter in the General Theory of Employment, Interest and Money, in which he uses the phrase* ***"prospective yield" to refer to the intrinsic value of an asset****:*
>
>> *"It is not sensible to pay 25 for an investment of which you believe the prospective yield to justify a value of 30, if you also believe that the market will value it at 20 three months hence…*
>>
>> *Human nature desires quick results, there is a particular zest in making money quickly, and remoter gains are discounted by the average man at a very high rate.*
>>
>> ***It is, so to speak, a game*** *of Snap, of Old Maid,* ***of Musical Chairs****—a pastime in which* ***he is the victor*** *who says Snap neither too soon or too late, who passes the Old Maid [card] to his neighbor before the game is over,* ***who secures a chair for himself when the music stops****."*

[152] Bernstein, Peter; Capital Ideas, page 117-118

The Next Guy Theory tells you all you need to know

Bernstein's perspective is instructive for venture-stage companies. Valuation is a pretty straight forward measure to calculate, but evaluating whether one is high, low or just right is a highly subjective matter. Keynes zeroed in on the importance of the "prospective yield" in determining the "intrinsic value" of a stock. Essentially, this is the Next Guy Theory of pricing for an investment, described in chapter four as:

> *For an investment, the price is no more than what the buyer believes the Next Guy will pay, less a discount.*

No matter how you evaluate a valuation, it boils down to an effort to figure out what the Next Guy might pay. It may be driven by mathematical exercise but ultimately it is a bet on human behavior.

To appreciate this, let's first examine the quantifiable issues that effect how a valuation is evaluated. Then, we'll look at some of the non-quantifiable, emotional ones

Is there an intrinsic value?

Finding a way to define and assess an intrinsic value to a company has long been the Holy Grail of financial market theorists. If one could discern it, one would know which stocks to sell or to avoid buying for the reason that they were overvalued. If a stock was selling below its intrinsic value, it might be promising to buy it. If investors knew a company's intrinsic value, they would be less susceptible to FOMO—*Fear Of Missing Out*—when valuations rose on a speculative basis.

Peter Bernstein wrote that "the most rigorous, and also the most influential, method for determining intrinsic value was published in 1938 by John Burr Williams," in his dissertation for a doctoral degree in economics. [153] Bernstein adds that Williams' "solution continues to be applied to almost all valuation problems…it provides the only formal method for determining what a price/earnings ratio or a dividend yield should be. Comparing that ratio or yield gives an indication of whether the asset is cheap or expensive."

Williams developed a theory of intrinsic value that "rests on the proposition that an asset is worth only what its owner can get out of it" which he defines as the sum of its future cash flows discounted to its present value for the time value of money. By extension, the present value of a company, its intrinsic value from an operating point of view, is today's value of the cash flows it generates in the future.[154] An operating point of view assumes the business continues to operate; a liquidation perspective considers value from the point of view of a buyer of the entire company or its key assets.

Money expected in the future is never worth as much as money on hand today because of the time value of money—which is the interest rate that one could earn if the money were available now, plus, the risk that the money will not actually be there when expected. Bernstein continues "The process of giving future payments a haircut to allow for uncertainty and the passage of time is known as

[153] All quotes and many of the ideas in this section about intrinsic value are from pages 149 to 162 of the 1992 book *Capital Ideas: The Improbable Origins of Modern Wall Street*, by Peter L. Bernstein, The Free Press

[154] It is convenient to use net income as a proxy for cash flow, but there is a difference. Non-cash related expenses include the accrual of liabilities and the amortization (depreciation) of assets. Investors care more about cash flow—cash generated or consumed—than income as defined by accounting standards.

discounting, and investors call this valuation technique the Dividend Discount Model [or Discounted Cash Flow (DCF) model]. The model is applicable to any kind of investment that is designed to produce cash flows to its owner in the future.[155] Few investors perform the elaborate calculations required by the model. Yet, no other formula for determining intrinsic value makes sense."

In the case of the DCF valuation model, the strange thing is that one must forecast cash flows to infinity in order for the formula to work. So, for example, if one wants to forecast the value of a company five years out, one must project cash flows over the next five years, of course, but also what it will be annually, starting in year six, in perpetuity. The value that runs from, in this example, year six to infinity is called the "terminal value." It is clearly an act of necessary make-believe. Chapter ten has Maynard Webb's observation that one third of the Fortune 500 companies as of 1970 no longer exist. Product life cycles are rapid and dominance in one phase is no assurance of continued success (e.g., Microsoft, Nokia, Sony, Toys R Us, Sun Microsystems, AOL Time Warner, etc.). As absurd as the terminal value assumption is, it's a necessary fiction for the DCF calculation to work.

Therefore, "the most rigorous, and also the most influential, method for determining intrinsic value" for a company that makes a mobile software application must forecast cash returns far beyond any credible assumption about the life cycle of the platforms that it plans to operate on. An innovative food product or a new technical device is expected to be generating returns 10, 20 and 40 years later. Here, theory clearly does not reflect experience.

Mathematicians who theorized about intrinsic value of financial assets in markets recognized this problem, which was acute in the case of "growth stocks"—companies whose earnings and dividend streams were expected to rise continuously into the future. In 1957, David Durand, a MIT professor of economics, wrote that:

> *Growth stocks…seem to represent the ultimate in difficulty of evaluation. The very fact that [this extrapolation problem] has not yielded a unique and generally acceptable solution to more than 200 years of attack by some of the world's greatest intellects suggests, indeed, that the growth-stock problem offers no great hope of a satisfactory solution.*

Thought Experiment
What is the intrinsic value of a company that is acquired for stock by a company that is overvalued?

[155] Not all investments are designed to produce future cash flows. An investment in research or art come to mind. So too, an investment in infrastructure or preventative maintenance.

How Valuation Experts Approach Valuation

Despite the challenges, the question, "what is a company worth?" often demands an answer. Most acutely by parties to a negotiation about price. Less urgently, by those who account for an acquisition in the months and years that follow the event.

Interestingly, those who negotiate the price often don't rely on valuation experts. It may sound curious because, after all, isn't that what valuation experts do…establish the price? The answer is "no." Valuation experts are not deal makers; they rarely establish price. Rather, after the deal is done, they assess how to account for the negotiated price. In other words, if they find that the price of a company, like any other asset, was higher than what it is worth, it results in a write-down in the asset's value—the recording of an expense.

So, how do valuation experts estimate how much a company is worth? They evaluate it from three perspectives—the income approach, the asset approach and the market approach.

The income approach provides the highest measure of enterprise value for a start-up because they rarely have valuable assets and their market value reflects expected income. To apply it, a discounted cash flow calculation is applied to a company's multi-year income projections.[156] Models vary sophistication but all rely on assumptions that require subjective judgement and are vulnerable to computational and logic errors.

Once projections are made, a discount rate is selected. The first step is to select a risk-free interest rate for the time value of money (i.e., rate on a U.S. Treasury note). The second step requires judgment; quantification of risk that the projections will not be met, and, the risk of converting the income to cash (i.e., liquidity risk, which relevant when earnings are in a foreign currency). The higher the risk, the higher the risk premium. The risk-free rate and the risk premium are added together to get a discount rate.

Discount rate = Risk-free interest rate + Risk Premium rate

So, if the risk-free interest rate is 3% and the risk premium is 14%, the discount rate is 17%. This is the "cost of capital", the rate of return required to attract risk-aware investors. There are tables that express a discount rate into percentage factors. These are applied to each period's earnings. The sum is the present value of the projected earnings

The asset approach to valuation considers what another party might pay for the assets or what it would cost to replace them. This approach is more likely to be used when a business is mature—it is rarely used to value a new company, which derives its value from its potential income.

The market value approach looks at the valuation of comparable companies. Interestingly, in a DCF calculation, value comes from income, but market value may be driven by revenue. The logic being that profits will follow or that revenue makes it more attractive as an acquisition.

Once valuation ranges using the income, asset and market approaches are in hand, a valuation expert will evaluate how to weigh them.

[156] If there is a significant difference between net income and cash flow, cash flow is used.

Weaknesses of valuation expert approaches

The combination of these three different approaches is intellectually impressive. Even so, the process does not consistently deliver practical value. If it did, valuation experts would be heavily relied upon by those who negotiate deals and established companies would not struggle to understand their value.

A fundamental problem exists when applying valuation methodologies to a start-up; such company is outside the "relevant range" of these techniques. That means an assumption about an activity loses relevance when it actual activity is higher or lower than expected. For example, costs considered to be fixed will not remain the same when volume is above or below the relevant range for the assumption.

Similarly, the logic used to measure value for an established firm may not be relevant for a startup, which has risks and opportunities that are not easy to assess. A startup that relies on innovative technology or a disruptive business model will have few comparable companies. Think of it this way, the strength of a chain is no greater than its weakest link—and when applied to startups, valuation methodologies have weak links.

The logic of the income approach is not its weakness, our inability to quantify risk and opportunity is. Another weakness of it is that start-ups are difficult to reliably forecast more than a year or two ahead. And the projections are the basis for all that follows—if they are unreliable, the discount rate doesn't matter. No matter how well constructed, a house will have flaws if it rests on a poor foundation. Another problem is that key assumptions often rely on subjective judgment that can be altered to deliver the results desired. Thus, the income approach can resemble a session with an *Ouija* board.[157]

What about the market approach? To speak to that, one must refer to valuation as price, not worth (income approach). Valuations often have a bipolar quality; they can climb and fall dramatically, out of proportion to what seems to be going on. This is apparent in the secondary market, where stock traders have a rule of thumb seemingly designed to feed volatility—"Buy on the rumor, sell on the news." It happens in the private market in a more dramatic, "sudden-death" fashion because valuation comes up when a company needs money. Thus if it's hot, the valuation will surge, if it's distressed, the valuation crumbles.

Valuation experts are no better than astute observers at explaining or forecasting price. They could not reasonably anticipate that the start-up ride sharing company Uber, for example, would be valued (priced) at $18 billion, as reported in mid-2014.[158] They would be unable to justify that unless comparable businesses, like Lyft, were similarly valued.

What is Lyft's valuation? Reportedly, $275 million in March 2013[159] and $700 million a year later, when Uber set the $18 billion mark.[160] [Dear Reader, for fun, check what it is when you read this.]

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[157] *Ouija* is a game played with a board that has letters and numbers on it. In a spiritual séance, players place their fingers on a small heart-shaped slider, taking note of where it points. Supposedly, the slider is guided by mysterious spirits that know the answer to questions the players ask.

[158] "Why Uber Might Well Be Worth $18 Billion", by Andrew Ross Sorkin, New York Times, June 9, 2014 http://dealbook.nytimes.com/2014/06/09/how-uber-pulls-in-billions-all-via-iphone/

[159] "With New Investment, Lyft Valued at $275 Million", by Evelyn M. Rusli, May 23, 2013, Wall Street Journal http://blogs.wsj.com/digits/2013/05/23/with-new-investment-lyft-valued-at-275-million/

[160] "Lyft Raises $250 Million Series D To Fight The Car Wars", by Jeff Bercovici, April 2, 2014, Forbes, http://www.forbes.com/sites/jeffbercovici/2014/04/02/lyft-raises-250-million-series-d-to-fight-the-car-wars/

Rules of Thumb

Another way to evaluate a valuation is to utilize rules of thumb such as a multiple of revenue, earnings or some other proxy for value like the number of customers. Use of a multiples of earnings before interest, depreciation (or amortization) and taxes (EBITDA for short) is popular, for instance. Some investors insist on paying no more than a multiple of the last round.

A multiple provides an approximation of value, albeit an arbitrary one, without a need to perform complex calculations. In the secondary market, an investor may have rule of thumb based on fundamental analysis, like the price/earnings ratio or on forms of technical analysis (i.e., pattern analysis, moving averages, etc.). Rules of thumb vary based on a company's industry, stage of development, geography and by investor. They are a convenient way to compare different companies.

Non-Quantifiable Factors—the Power of Love, Reputation and Charisma

More often than you might think, non-quantifiable factors affect how a valuation is evaluated. Caution can be thrown to the wind when the investor loves the idea and entrepreneurs. This happens to individual investors. But, as mentioned in chapter twelve, Garage Ventures' Bill Reichert reports that it happens to professional investors as well. Another such anecdote is provided by David Kilpatrick in his 2011 book *The Facebook Effect*. [Bold added for emphasis]

> *In venture capital deals…the investor usually forces the existing shareholders to dilute their ownership prior to the investment by adding a "pool" of shares that will remain unallocated, on the assumption that future employees will get some of their pay in stock options. The way it's calculated is complicated, but it has the effect of giving the VC more of the company and the entrepreneurs less. VCs typically insist that the existing shareholders of a company accept a pool of about 20 percent.*
>
> *But [a Facebook co-founder] had prepared [CEO Mark] Zuckerberg for this gambit, and it was clear at dinner the night before how badly [Accel Partners' Jim] Breyer wanted to invest. So Zuckerberg refused the 20 percent dilution. The two agreed on a 10 percent option pool instead. In addition, Zuckerberg would only accept half of that being applied to existing shareholder's ownership. So some of the dilution applied to Accel's money as well. "Mark negotiated really hard," concedes Breyer.*
>
> *They finally agreed on a deal that would value the company at slightly less than $98 million post-investment. Accel would invest about $12.7 million—a stunning sum for such a small company. It would own about 15 percent of the company.* ***"I knew the price was way too high," Breyer says now, "but sometimes that's what it takes to do the deal."*** *Breyer agreed to go on the board but asked if he could invest $1 million of his own money. The twenty-year-old and the VC shook hands. Zuckerberg left his office, and Breyer was elated.*[161]

What causes an investor to fall in love with a prospective investment varies. Clearly, the business opportunity plays a critical role but so does the strength of the executive team.

[161] Kilpatrick, David; "The Facebook Effect: The Inside Story of the Company That Is Connecting the World", 2011, Simon and Shuster, page 124-125.

For some, however, the team is more important than the business. The saying—"Bet on the jockey, not on the horse"—captures this sensibility." It's a way of stating that a smart, savvy CEO will make a great business achieve its potential and make a not-so-great business better than it might otherwise be. Interestingly, investors may value a company more highly than otherwise if a CEO has a reputation for delivering. A dream team makes investors more willing to accept a valuation because they make a good outcome more likely.

But the jockey effect can also lead to a hyped valuation. Imagine *two companies with comparable prospects*. One is led by a star, the other by someone less accomplished. The one with the hot CEO may fetch a higher valuation than can be explained by reduced risk; a valuation premium based on a halo or celebrity effect. Investors think "if so-and-so is on board, this is likely to be big!" From a valuation perspective, this is both understandable and curious. It is reasonable to favor a star CEO over an unproven one from a risk perspective, it is questionable whether a star makes the opportunity bigger.

Interestingly, a set of stars may not make a strong team; some may have trouble sublimating their egos to achieve goals that require collaboration. Also, past success doesn't assure future success, as many boards of directors have seen. That said, a CEO with a good reputation who puts the interests of others ahead of his or her own is the kind of jockey all investors want. Angel investor John Huston put it this way:

> *The one commonality of the successful exits we've had is simply this: the team, led by the CEO, was successful in convincing our due diligence team that they would be profoundly, personally embarrassed if they couldn't give us our money back with a nice multiple in 5 years.*[162]

In his 2011 book, *The Business of Venture Capital*, Mahendra Ramsinghani describes qualitative factors that VCs consider when they evaluate a company and its valuation. He writes that Geoff Smart, co-author of the 2008 book, *Who: The A Method for Hiring,* sought to discover what kinds of CEOs make money for investors. To find out, Smart teamed up with Steven Kaplan, a professor of entrepreneurship and finance at the University of Chicago. Ramsinghani writes that [bold added for emphasis]:

> [Smart and Kaplan] *went on to conduct the largest study of CEO traits and financial performance. The results were compelling and controversial. Data from 313 interviews of [private equity]-backed CEOs were gathered and analyzed. Taking these assessments, the authors matched the CEO assessments with actual financial performance.*
>
> *Smart points out that investors have a tendency to invest in CEOs who demonstrated openness to feedback, possess great listening skills, and treat people with respect. "I call them 'Lambs' because these CEOs tend to graze in circles, feeding on the feedback and direction of others," he says. And he concludes that investors love* ***Lambs*** *because they are easy to work with and* ***were successful 57 percent of the time.***
>
> *But Smart found that the desirable CEOs are the ones who move quickly, act aggressively, work hard, demonstrate persistence, and set high standards and hold people accountable to them. (He called them "Cheetahs" because they are fast and focused.) "****Cheetahs in our study were successful 100 percent of the time.*** *This is not a rounding error. Every single one of them created*

[162] http://videos.gust.com/pages/john-huston

significant value for their investors," writes Geoff. He and his coauthor conclude that "emotional intelligence is important, but only when matched with the propensity to get things done."

Separately, Steve Kaplan's research leads to the same conclusion. In the study "Which CEO Characteristics and Abilities Matter?" the authors assess more than 30 individual characteristics, skills, and abilities. Surprisingly, the study showed that ***success was not linked to team-related skills*** *and that such skills are overweighed in hiring decisions.* ***Success mattered only with CEOs with execution-related skills.***[163]

Ramsinghani addressed other reputational factors as well. He writes that integrity and honesty are fundamentally important qualities but hard to assess. With respect to experience, he references a study of serial entrepreneurs that concludes: [bold added for emphasis]

All things equal, a VC-backed entrepreneur who has taken a company public has a ***30 percent*** *chance of succeeding in his next venture. A failed entrepreneur is next in the pecking order with a* ***20 percent*** *chance of success and a first-time entrepreneur has an* ***18 percent*** *chance. Researchers assessed the cause of success and point out that successful entrepreneurs know how to launch companies at the right time—before the markets get crowded.*[164]

This finding will be surprising to the many people—it was to me—because it is commonly thought that having an experienced, successful CEO (and other executives) on-board suggests less risk, if not more potential, thus a valuation premium. But the evidence Ramsinghani cites indicates that having a CEO with prior success increases the likelihood of success from roughly two in ten—the odds for CEOs that experienced and failed or those with no experience—to three in ten.

A Silicon Valley veteran told me that "VCs value formation of a 'team' as a proxy for execution"—a valuation premium. Again, this seems intuitive, after all, a sports team loaded with stars seems like it should be more valuable than one without a lustrous roster. But, what if the stars don't deliver? Does value flow from anticipation of performance or from the delivery of it?[165] Does valuation reflect hope or results? Variations of these questions can be formulated for other areas. Nonetheless, there is reason to believe that the valuation premium associated with prior success may be outsized. This will be one of many provocative points that comes up in discussions about the Fairshare Model.

Ramsinghani writes the following on the importance of team building, which further tempers the idea that a company should be valued more highly because of its team, before they deliver results.

"Do they understand their own limitations and weaknesses? Are they able to attract a team, and eventually, can they recruit their own CEO and replace themselves?" ask Lip-Bu Tan of Walden International.

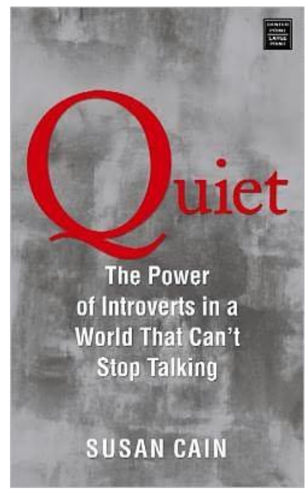
These qualities are fundamental but rare—after all, human beings suffer from insecurities. If they attract team members who are highly accomplished, they may end up looking like dwarves. Or

[163] Ramsinghani, Mahendra; "The Business of Venture Capital"; 2011; Wiley, page page 182-183
[164] Ibid, page 183
[165] There are limits to this analogy. The value of a sports franchise is be based on revenue and profitability, not its winning record.

get sidelined! And very few can overcome this innate and primal urge—most gravitate toward looking smart in a land of dwarves as opposed to looking stupid among giants.

An investor needs to watch for traits where the founders or the core management team are able to attract star power. Most management teams will be replaced, either by choice or by sheer exhaustion in the travails of the start-up journey. Team building can make an investment opportunity stronger. A simple question to consider: Is this person honest and bold enough to replace him-or herself at the right time or even become redundant?[166]

Charisma is another intangible that can affect how a valuation is evaluated. An investor who is charmed by the leadership will like the company, maybe love it. This can lead to a valuation premium, if for no other reason that a high one is not questioned. However, charisma is that it is not closely associated with performance, as Susan Cain noted in her 2012 book *Quiet.*



The essence of the Harvard Business School education is that leaders have to act confidently and make decisions in the face of incomplete information. The teaching method plays with an age-old question: If you don't have all the facts—and often you won't—should you wait to act until you've collected as much data as possible? Or, by hesitating, do you risk losing others' trust and your own momentum?

The answer isn't obvious. If you speak firmly on the basis of bad information, you can lead your people into disaster. But if you exude uncertainty, then morale suffers, funders won't invest, and your organization can collapse. The HBS teaching method implicitly comes down on the side of certainty. The CEO may not know the best way forward, but she has to act anyway.

Yet even at HBS there are signs that something might be wrong with a leadership style that values quick and assertive answers over quiet, slow decision-making. Contrary to the school's model of vocal leadership, the ranks of effective CEO's turn out to be filled with introverts.

"Among the most effective leaders I have encountered and worked with in half a century," the management guru Peter Drucker has written, "some locked themselves into their office and others were ultra-gregarious. Some were quick and impulsive, while others studied the situation and took forever to come to a decision…. The one and only personality trait the effective ones I have encountered did have in common was something they did not have: They had little or no 'charisma' and little use either for the term or what it signifies."

Supporting Drucker's claim, Brigham Young University management professor Bradley Agle studied the CEOs of 128 major companies and found that those considered charismatic by their top executives had bigger salaries but not better corporate performance.[167]

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[166] Ibid, pages 180-183

[167] Cain, Susan; "Quiet: The Power of Introverts in a World that Can't Stop Talking", Crown (2012), page 45-46, 53-

It is easier, to be uncharismatic and effective when a business is established or in a turnaround situation. For a start-up, however, leadership charisma can play a more critical role. After all, like a magician or a ringmaster at a circus, the CEO is asking audiences to imagine possibilities, to have enough imagination to invest in, be a supplier to, or work for an enterprise that is doing something difficult when the prospect for reward is questionable.

If the opportunity is preternaturally compelling, CEO charisma may not be critical. But for many start-ups, a certain charm is necessary to cause investors to pay attention, to see the potential, to believe this team can achieve it and, finally, to actually write the check. It is one thing for charisma to encourage an investment, however, and something else for it to lead investors to accept a high valuation. It can be the difference between a healthy ego and narcissism: subtle but detectable. The thing about charisma is that you don't have to be competent to have it. Plus, it can lead investors, colleagues and the CEO him or herself to be overly confident.

There are an array of non-quantifiable factors that influence how investors evaluate a valuation--love, reputation and charisma are but a few.

Quantifiable factors for evaluating valuation

All investors rely on rules of thumb and non-quantifiable factors to evaluate a valuation because there isn't an intrinsic value to a venture stage company that can be reliably discerned. But sophisticated investors calculate *what the company's pre-money valuation should be* if they are to make the return they want on the investment. In other words, they don't calculate what the valuation actually is, they calculate the highest valuation they should pay to have a chance to make the money they want to make.

The calculation requires the investor to set a target rate of return for an investment with this expected risk, reward and length. It also requires prognostication of these variables:

- Expected value of the company at investor exit; and the
- Expected size and timing of future capital raises (i.e., how many more rounds of capital, and the share of the company they will buy).

The calculation works backwards. It takes the estimated exit value, deducts the expected dilution that will occur in future rounds to arrive at the future value of ownership now. Then, that value is discounted for investor's target rate of return. The result is an approximation of the maximum pre-money valuation the investor can accept and still expect to make its target return.

The details are too technical for this book. Besides, it's not relevant to public investors. They lack the opportunity to negotiate the pre-money valuation. Plus, they can sell before future ownership dilution occurs.

The take-away, however, is that sophisticated private investors often calculate the maximum valuation they can pay and still meet their goal.

How VCs Evaluate a Valuation

VCs routinely calculate the buy-in valuation they can accept using the approach above. They are also extraordinarily plugged into what is driving valuations. They hear what other VCs are doing. They know what potential acquirers and investment bankers are telling their portfolio companies. They may have board seats at companies that are in the space they invest in. They participate in networking events and hear from entrepreneurs who are at every point in the cycle. They have lots of eyes and ears on the ground.

So, they are expert assessors of valuation. But no one can know everything or reliably foretell the future. Therefore, VCs rely more on deal terms to protect them from overpaying than they do on calculation or negotiation. [See "Valuation is a Challenge for VC and PE investors" in chapter twelve.]

That is, to secure a position in a deal they want, a VC will accept a high valuation if they get price protection provisions (e.g., liquidation preference, dividends, etc.) and/or board control. These provisions are defensive in nature. They also secure offensive provisions—those that secure their right to invest more when a deal looks like a winner.

How Angel Investors Evaluate a Valuation

Like VCs, angel investors rely on rules of thumb and non-quantifiable factors to evaluate valuations. When they invest in businesses sectors that they know, or someone who they collaborate with knows, they have an informed opinion about what constitutes an attractive valuation. That's a way of saying that angel investors, especially those active in an angel investor group, rely more on their network to evaluate a valuation, whereas VCs rely on deal terms. Angel investors who are not well networked are disadvantaged in all aspects of the investment evaluation—due diligence and valuation.

David S. Rose is CEO of Gust, an online platform (www.gust.com) that is a terrific resource for angel investors and for entrepreneurs who want to pitch to them. In his 2014 book *Angel Investing: The Gust Guide to Making Money & Having Fun Investing in Startups*, he describes a variation of the calculation that was described on the prior page. He writes:

How much money you make from your angel investing is determined by four simple numbers:[168]

1. *The value of the company when you invest.*
2. *The value of the company when you sell.*
3. *The number of years between these two events, which, taken together, give you your rate of return.*
4. *The rate of return, multiplied by the amount of money you invest, will determine your ultimate angel investing bottom line.*

That first number, of course, is the pre-money valuation. Rose calls it "the single most important of the four simple numbers." He also refers to it as "the most confusing, debated and variable number in the world of angel investing."

[168] "Angel Investing", by David S. Rose, Page 94

In his book, Rose explains how to use the four numbers to estimate how much money an investor will make, including approaches that angel investors can take to evaluate the pre-money valuation of a private company. One thing he says about the process is relevant to public investors. He feels a 25% rate of return is roughly what angel investors should target, which is, as he point out is "a return that compares favorably to almost every other legal form of investment."[169] That may surprise readers accustomed to earning far less on their money but that rate reflects the risks that private venture-stage investors assume. Chief among them is the lack of liquidity. Once they invest, they are strapped in for the duration of the ride—no acquisition or IPO means little ability to convert their position into cash.

Beyond the expected difficulty of estimating the valuation of a company at investor exit and the time it will take to get there, angel investors face uncertainty about the percentage of ownership they will have in the company when the exit occurs. That's because the price protection that a VC secures comes at the expense of other shareholders.

Angel investors can correctly predict the exit value and time it takes to get there but vastly overestimate their return if they underestimate much capital, and what kind of capital, it takes to get there. For example, say that angel investors own 20% of a company that they expect will be valued at $30 million at exit, when they will own 10% or $3 million. They can be right about the exit value but very wrong about their stake; they could end up with 2% or $600,000…or even zero! How is this possible?

- An unplanned capital raise or a down round will trigger price protection provisions that the second round VC has, which dilutes the position of the first round angels.
- A VC may evoke a "pay-to-play" provision. This requires all investors to invest in a new round to preserve their ownership stake or lose much of their investment. In a pay-to-play scenario, investors who want to retain their ownership position ("play"), must invest more ("pay") in a new raise.
- A VC with a liquidation preference is entitled to recover it before other shareholders participate in the split of what remains. The preference is a multiple of the VC's investment.
- Professional investors may have the right to a dividend and/or management fee, which is compensation for the time the investment team spends overseeing their interests, but this is unlikely to be a significant issue unless the exit takes a lot longer than expected.

These glum possibilities don't necessarily affect how angel investors evaluate a valuation, though. After all, if they want to invest, they are excited and optimistic enough to believe things go as planned. Down rounds are never in a forecast. So, even though the projected exit value is spot on, changes in the timing of cash flows or shifts in the capital markets can drive a company to get the cash on terms that ultimately have adverse consequences for the angel investors.

Such possibilities shed light on why it can be so difficult for angel investors to evaluate "the single most important" number for an early round investment in a start-up.

[169] Angel Investing", by David S. Rose, Page 96

Valuation Evaluation---As Seen On TV!

In 2009, as the U.S. worried about how get out of the Great Recession, the ABC television network debuted an entrepreneurial "reality show" called *Shark Tank*.[170] It's like a talent show, but instead singing or dancing for judges, contestants pitch their startup idea to a panel of wealthy investors, who are called the "Sharks."

Novice entrepreneurs describe their business, demonstrate the product/service, then say "I offer X percent of my company for Y dollars." The amount seems to range from $30,000 to $300,000—a seed round size or early stage deal.

> It is remarkable to me that a show that deals with startup valuation entered pop culture. This was a foreign matter to most people until recently. *Shark Tank* raised awareness of deal terms, just as I hope the Fairshare Model will.

What follows is a bit of Q&A about the product/service, sales history/prospects and profit margin. The Sharks then critique the pitch and announce whether they are "out" of the deal or willing to entertain an offer. Competing bids occur.

Entrepreneurs always want the money and control. Counter offers are nearly always for a lower valuation and often require control. For example, an entrepreneur may offer 20 percent of the company for $300,000, a $1,200,000 pre-money valuation.[171] But a Shark is likely to counter with 51 percent (a $288,235 pre-money valuation) for the same money.[172] Sometimes, the counter has a royalty and/or loan component. Changes in deal terms can be hard for an entrepreneur to evaluate on camera, particularly if a royalty is involved and Sharks are saying "don't take that deal" or "you have an offer—decide now."

The show provides a reality-show like glimpse into the dynamics of valuation and deal structure. Watch some episodes and you'll see that the TV Sharks offer the lowest valuation they think they can get, but also look to secure at least one of the following:

- Ownership control—51 percent;
- Recovery of their investment, hence, a royalty;
- Leverage if the entrepreneur doesn't perform. Hence, a debt element, which can foreclose on the equity.

As an aside, royalty deals are generally a bad idea for a company, especially it margins are not high. They handicap the appeal of the company to new investors when more money needs to be raised.

Most angel investors and VCs see equity as mother's milk for venture stage companies and, so, don't require royalties.

[170] Shark Tank episodes are on YouTube
[171] ($300,000 investment/20% ownership) - $300,000 investment = $1,200,000 pre-money valuation
[172] ($300,000 investment/51% ownership) - $300,000 investment = $288,235 pre-money valuation

How Private Equity Investors Evaluate a Valuation

Variation in the type of professional investors that engage in venture capital investing has grown since the 1990s. Once the province of venture capitalists, private equity firms and their variants (hedge funds, buyout firms, etc.) also engage in it. But they evaluate valuation in a differently way.

VCs invest in companies that are creating a business. Many of them are visionaries, like the entrepreneurs they back, in that they seek to create entirely new markets or to transform existing ones. They are like athletes who create their own momentum; weight lifters who lift from a standing start. Like gardeners who work with plants at a seed or sprout stage. Most significantly, they finance their companies with their own fund's money—if there is any debt, it is from equipment lessors.

PE firms invest in at a later stage, when there is an established business with assets that can be borrowed against. They are like gardeners who trim established plants, put them in a larger pot. Such investors are more opportunistic than visionary; they aren't interested in creating something new, they want to make something already in motion go forward, faster. It is hard to generalize beyond that because PE firms play in a bigger sandbox than VCs do—their stage of development spectrum is broader.

On the startup end of the spectrum, PE favors companies with existing products for which there is an attractive market. The gambit is that the company can accelerate its growth and improve its efficiency with the PE firm's capital, insight and connections. On the mature end of the spectrum, they invest in companies that could be worth a lot more with a makeover.

PE firms have the advantage over VCs when it comes to assessing a valuation. There is a historic trend to examine, much like an investor can see a public stock's trend. Their bet is that they can help it rise faster or fix what's wrong and then sell it at a profit. They have another advantage over VCs—because there is an existing business, they can structure their investment as debt or, even better, they can get others to lend the company money that can be used to buy the company.

Because cash flows are easier to project for an established business and repayment of debt plays a prominent role in building value, a PE firm will pay a lot of attention to a DCF analysis. As a result, their formula for success is a more precise version of the Next Guy theory. The three strategies that a PE firm can use to increase the value of their equity stake in a company are:

- Pay down the debt used to acquire the company by selling off assets (i.e., facilities or lines of business);
- Increase the earnings multiplier by re-positioning the business to focus on high growth and/or more lucrative markets; and
- Grow the income by increasing revenue and reducing expenses (i.e., cost reductions, drop low margin products, consolidate facilities, etc.).

How these strategies can pay off is presented on the next page.[173]

[173] Tip of the hat to Brad Winegar of Salt Creek Capital, a leading private equity firm in the San Francisco bay area, for providing this presentation.

The table to the right shows a company with income of $1 million dollars that a PE investor acquires for $5 million—so, it is valued at a 5X earnings multiple.

To finance the purchase, the PE fund found a lender to lend the company $4 million, based on its assets, income and the PE investor's involvement. As a result, the PE investor makes a $5 million investment using just $1 million of its own money. The company's selling shareholders are paid $5 million, but $4 million of it came from money that the company borrowed, not the PE firm.

	Status at Acquisition
Earnings	$ 1 M
Earnings Multiple	5.0 X
Enterprise Value	$ 5 M
Debt	$ (4 M)
Equity	**$ 1 M**

The next table adds three columns to the one above, one for each way a PE investor will try to increase the value of its equity stake before it has an exit (i.e., an IPO or sale to another party).

	Status at Acquisition	**Pay-Down Debt**	**Increase the Multiple**	**Grow Income**
Earnings	$ 1 M	$ 1 M	$ 1 M	**$ 2 M**
Earnings Multiple	5.0 X	5.0 X	**6.0 X**	6.0 X
Enterprise Value	$ 5 M	$ 5 M	$ 6 M	$ 12 M
Debt	$ (4 M)	**$ 0 M**	$ 0 M	$ 0 M
Value of PE equity stake	**$ 1 M**	**$ 5 M**	**$ 6 M**	**$ 12 M**

Let's walk through each of them, assuming they occur in succession:

- The "Pay-Down Debt" column reflects the sale of assets that are not critical to the company's new strategy. The proceeds are used to retire the $4 million debt. As a result, the value of the PE firm's equity stake rises from $1 million to $5 million. The company's value is unaffected, as it is function of earnings…the amount and the multiple.

- The "Increase the Multiple" column shows the effect of increasing the earnings multiple, here, from 5X to 6X. This occurs when the company raises its profile with investors by focusing on a fast growing market or better public relations. The effect is to raise the enterprise value of $1 million in earnings from $5 million to $6 million (compare to prior column). With no debt, the PE equity stake is $6 million, which is 20% more than the $5 million after the debt is paid off or 500% more than the value at acquisition.

- The "Grow Income" column shows the effect of growing income—earnings double from $1 million to $2 million. Since the multiple is 6X, that translates to $12 million in enterprise value.

Accomplishing all three steps—no trivial task—means that the PE firm grows the value of its position from $1 million to $12 million, a 12X or 1,100% return.[174]

A PE investor will negotiate the lowest valuation it can up front and the highest valuation at exit, like anyone else would. But it has ways to minimize its at-risk investment and more ways to grow the value of its stake than a VC or angel investor, thus it will evaluate a valuation differently.

[174] 1,100 percent return = [$12M value - $1M investment]/$1M investment)

Evaluating the Valuation of a Company That Uses the Fairshare Model

Does the Fairshare Model change how a company's valuation is assessed? You betcha (as they say in the Midwest)! That's it's *raison d'etre* (as they say in France) or reason for existence!

The premise, as you well appreciate by now, Dear Reader, is that it is very hard to come up with reliable valuation for a venture stage company. So, why have one? This was touched on at the end of chapter twelve. But, why make it as consequential as it is now?

In medicine, if we had an unreliable test for a condition where the treatment was consequential and also had a high chance of being wrong, there would be clamor for a better way. A better test. A way to delay imposing the treatment on the patient. Or a better treatment.

The similarity is this: absent a more reliable way to value a startup, shouldn't we explore ways to delay the partitioning of interests between those who provide ideas and labor, and those who provide capital? If you have made it this far in the book, you are clearly open to it.

So how should the valuation of a company be viewed when an issuer uses the Fairshare Model?

1. As something that will change, possibly dramatically, based on the conversion rules and performance.
2. As something set for strategic reasons, not because that's what it "should be" from an economic sense. [One might conclude this about valuation using a conventional capital structure.]

An issuer's strategic reasons for setting the IPO valuation where it does with the Fairshare Model will vary by constituency but they will overlap, as you can see below.

- IPO investors: Issuer is motivated to offer a low valuation designed to create enough investor interest in the offering that it is fully subscribed in an expeditious manner.
- Secondary market investors: A low IPO valuation will promote a Black Friday sale mentality, which promotes secondary market trading. If the price of Investor Stock climbs, which is good for the issuer's pre-IPO and IPO investors.
- Pre-IPO investors: If these investors are long-term investors, they will not be not be bothered by the low IPO valuation. That's because a VC, the alternative funding source, would want a low valuation too. Not only that, it would require deal terms that could squeeze the other investors out. These benefits can mollify pre-IPO investors concerned about the low IPO valuation. Further inducement can come in the form of warrants on the Investor Stock or participation in the Performance Stock pool.

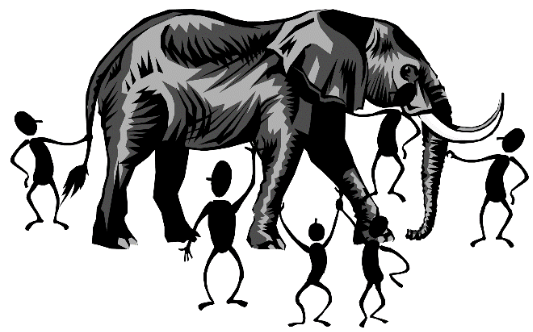
- Founders/Management: A high IPO valuation satisfies the desire for wealth and an ego boost. Here are factors that could make a Fairshare Model offering appealing to offset the allure of those factors:
    - The management team defines the conversion criteria.
    - If the team performs well, they can own more of the company's tradable stock than they would if the money came from VCs.
    - Their willingness to be capital structure innovators will create popular interest in the company and its leadership team. That will create awareness and interest in their company that can pay dividends in virtually every aspect of the business.

Closing thoughts

How should one evaluate a valuation? It's a bit like evaluating a piece of art—opinions vary. The question reminds me of a poem by the 19th century American poet John Godfrey Saxe called *The Blind Men and the Elephant.* Inspired by fables from several religious traditions in the Indian subcontinent region, it illustrates the limits of analytical thinking and the risks of fragmented knowledge.

Saxe tells of six learned men from Indostan "who went to see the Elephant, though all of them were blind." The one who feels its tail concludes that the elephant is like a rope. The one who feels its side proclaims the beast is very much like a wall. The one that grasps its feet declares it is clearly like a tree. The one that touches the ear says it's more like a fan. The one that strokes the tusk concludes a spear is more apt while the one that encounters its trunk insists that the elephant is like a snake. The poem concludes:

And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong,
Though each was partly in the right,
And all were in the wrong!



The story suggests how to assess a valuation; consider multiple perspectives, including the possibility that they may be wrong. This moral leads one to question the appeal of a conventional capital structure, which demands certainty about the value of future performance.

Dear Reader, there is much advice available on how to evaluate a valuation. I hope this chapter encourages you to learn more. Do your research, seek out the most knowledgeable people you can, then find other sources. Persistently ask "How?" and "Why do you think that's the best way?"

By the way, the way I evaluate a start-up valuation is to consider the likelihood that the Next Guy will pay more. This assessment hinges on external factors as well as internal ones. That is, the general state of the markets, the space that the company operates in, the projections and the risk associated with them. In particular, I pay attention to how long before the company will need more money. I look at how much it has now, how much it wants to raise and estimate how many quarters it will last. Finally, I try to imagine how attractive the company will look then. Also, the probability that current investors will invest more and likelihood that another company might acquire it.

Onward

The next chapter, the final one in the valuation section, presents a case for a valuation disclosure requirement in offering documents.

Chapter 15: Valuation Disclosure

Preview

- Foreword
- The Elephant in the Room
- Key Conclusions You Should Have In Mind
- The Case for a Valuation Disclosure Requirement
- What Valuation Disclosure Might Look Like
- What Disclosure of the Basis for the Valuation Might Look Like
- Valuation Disclosure – Why Hasn't It Happened Already?
- A Call for Action on Your Part
- Onward

Foreword

This is an important chapter if you favor one or more of the following:

- Market-based solutions
- Transparent investor disclosure (a/k/a open, candid disclosure of significant information)
- The Fairshare Model

This chapter asks you to petition policy makers require that issuers of stock plainly disclose and discuss the valuation they give themselves in their offering document.

The Elephant in the Room

Dara Albright is a New York based crowdfunding advocate who makes an intriguing comparison between the 1971 Intel Corporation IPO and the 2014 IPO of the much ballyhooed Alibaba Group.

	Intel Corporation	Alibaba Group
Year of IPO	1971	2014
Number of pages in the Prospectus	38 pages	325 pages (39 pages of "Risk Factors")
Amount raised	$7.5 million	$25 billion
IPO Valuation	$58 million	$170 billion
February 2015 valuation	$164 billion	$286 billion
Appreciation since IPO	282,659%	68%
For Alibaba's IPO investors to realize the same return as investors in Intel's IPO (who still hold the stock), Alibaba will need to trade at a $480 trillion market capitalization—six times more than the gross domestic product of every country on the planet combined!		

Albright presents this table when arguing that equity markets are in need of repair. That big financial institutions help channel immense amounts of capital to a few deals instead of modest amounts to small, job-creating businesses. And, that banks allocate IPO shares in a manner that benefit privileged investors instead of average ones. She argues that this constitutes a misallocation of resources and that equity crowdfunding can help correct it.

Her table prompts me to contemplate these points as well:

- Is it possible anymore to have a 38-page prospectus?
- Do disclosure documents now emphasize risk disclosure to a brain-numbing degree?
- Do disclosure requirements miss the proverbial elephant in the room, the valuation?

Not one of the 325 pages in the Alibaba prospectus states that it set its IPO valuation at $170 billion. The only references to valuation essentially said:

> *Prior to this offering, there has been no public market for our shares. The public offering price for has been determined by negotiation among us and the underwriters based upon several factors*.[175]

Well, knock me over with a feather! That's illuminating!

[175] Alibaba Group 2014 prospectus, page 62 and 267. Technically, the foreign-based Alibaba sold American Depository Shares that represented ordinary shares.

Implicitly, Alibaba, just like all the other issuers that similarly describe how their IPO price is set (i.e., virtually all of them), ask investors to view the matter as if it were the birth of Athena, the goddess of wisdom in ancient Greek mythology. As you may know, Dear Reader, she was born fully formed, as an adult, springing out of the head of her father, Zeus, not from her mother's womb. Athena was also associated with purity, for she remained chaste.

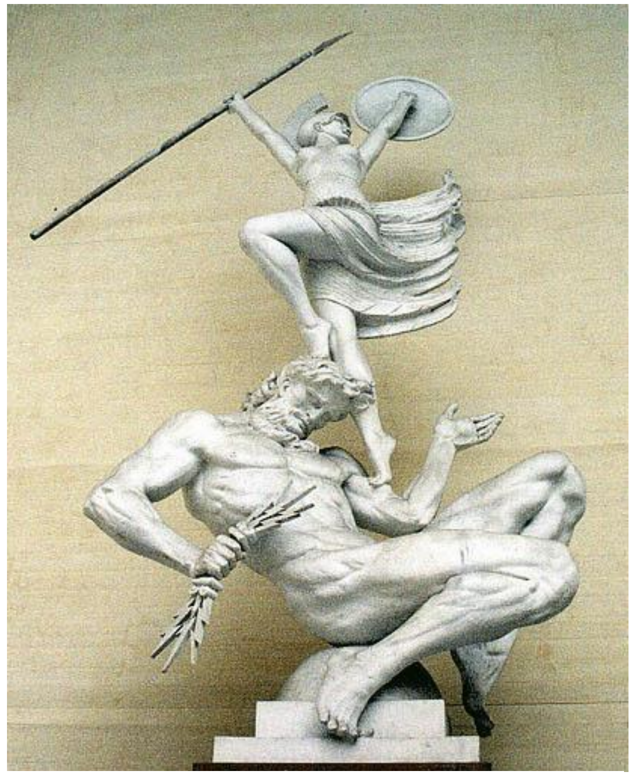
Issuers who make pronouncements like Alibaba's about their IPO valuation indirectly assert both wisdom and purity in the setting of its valuation.

The wisdom is from the investment bankers.

Purity is evoked in a virginal sense. As a public company, its valuation is unsullied by prior transactions in the capital markets.

Now, of course, all IPO issuers have a valuation history as a private company. Why this is thought to be irrelevant to public investors is a curious matter, indeed.[176]

All of this is, of course, as much the basis of myth as Athena herself. Factors other than wisdom inform where the offering price is set, and, all companies have a valuation history leading up to their IPO.



1 Statute depicts the remarkable birth of Athena, bursting out as an adult from the head of her father, Zeus.

But put the history to the side, what is the valuation? Investors need to pull it out of their head!

When it comes to valuation, the apparent, albeit unspoken, rule for offering documents is Don't Ask, Don't Tell. Investors should figure it out.

That seems, well, wrong-headed.

[176] It makes about as much sense as excluding the private sector background of a candidate for public office from disclosure or consideration.

Key Conclusions You Should Have In Mind

Dear Reader, let's review some of the conclusions that I hope you've reached by now:

- Valuation is an important determinant of investor risk and upside.
- Investors who are valuation unaware are more likely to make poorer decisions than those who are valuation aware.
- The issuer and its investment bankers decide what the valuation will be.
- Comparable companies can choose significantly different valuations.
- Valuation is "price" but it can easily be misconstrued as a representation of "worth"—investors can better evaluate the difference if the price is clearly stated.
- Valuation is different from price per share; companies with the same share price can have wildly different valuations.
- A simple calculation can determine a company's valuation—it is not rocket science.
- Many investors may feel uncomfortable computing an issuer's valuation or neglect to do so.
- Venture-stage companies are difficult to reliably value. (If he were an investor, the movie character *Forrest Gump* would compare them to a box of chocolates).[177]
- Historically, emerging growth companies have been associated with economic growth, job creation and, arguably, the ancient Aristotelian concept of the *Good Life*. If follows that all could be enhanced by improving entrepreneurial access to capital.
- Wall Street banks have been taking venture-stage companies public for decades; anyone how believes that average investors should not be allowed to invest in them should realize they already have the ability to invest in them.
- VCs can protect themselves from investing at an excessive valuation but public investors cannot.
- More venture-stage companies will be presented to public investors as a result of regulatory changes like the JOBS Act and evolving notions of how well-established a company needs to be before it is "ready to go public."

I'm about to make the argument for another conclusion that I'd like to share—offering documents should disclose the issuer's valuation. At present, they make prominent mention of the price per share but not the valuation.

The balance of this chapter is a call for regulatory change, for social and investor activism, designed to provoke a significant change in the market for equity capital. This chapter is an appeal for your help, Dear Reader.

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[177] Famous line from the 1994 movie, Forrest Gump's—*Momma always said, 'Life is like a box of chocolates, you never know what you're going to get."*

The Case for a Valuation Disclosure Requirement

The Jumpstart Our Business Startups (JOBS) Act makes it easier for companies to sell stock to investors who are wealthy (i.e., they meet the Securities and Exchange Commission's "accredited investor" standard) and also, potentially, to small investors. The law called for the SEC to authorize rules for "equity crowdfunding" (Title III) by the end of 2013. More than two years after that deadline, it hasn't happened, purportedly, due to the difficulty reconciling the JOBS Act with the SEC's mission to protect investors.

No matter how the law is implemented, the SEC (and state regulators) could do much to help investors protect themselves by requiring that all companies disclose the valuation that they give themselves when they offer stock. Not only that, such a requirement would also encourage companies compete for capital by offering better terms. When investors are valuation aware, they are more likely to recognize when a company has valued itself attractively. This awareness encourages companies to compete for public investors based on deal terms, which is good for investors.

> The SEC assumes that investors can and will calculate it themselves.
>
> This is remarkable, given how important the information is and how likely it is that an investor will fail to consider it.
>
> It is odd when one considers how many pages are devoted to mind-numbing risk disclosure whereas valuation disclosure could take one page and be of keen interest.

Valuation is occasionally cited in news reports, but many investors are unsure what valuation means. But you know, Dear Reader, that it is simply the price to buy the entire company, based on the latest price shares are sold at. When new shares are sold by an issuer, valuation refers to the "pre-money valuation". After the offering is complete (i.e., money is pledged for the new shares), it refers to "post-money valuation" or market capitalization.

Some investors know what valuation means but are unsure how to calculate it (chapter twelve shows how). Whether a company is privately held or publicly traded, the calculation assumes that stock is sold at market value and that the latest price is the value of each share outstanding. So, theoretically, it is what someone would pay to buy the entire company. Maybe it is. Maybe it's isn't.

Assume ABC Company has given itself a $50 million pre-money valuation. How might an investor evaluate making an investment in ABC's stock? If she knows the valuation (and its significance), it is easy for her to pose a fundamental question.

> *ABC Company has less than $1 million in revenue and no profit. Why should I invest when it is valued at $50 million?*

If the investor does not know ABC's valuation, her price related question will likely be "Why should I invest when it is $5.00 per share?" But this is not meaningful! ABC could have the same valuation with a lower price and more shares outstanding; the valuation equals the number of shares multiplied by the price.

The important question is *"Why is ABC worth $50 million?"* Investors who don't know this are at greater risk of making a poor decision.

Valuation is important information and investors should not, as they do now, have the burden of calculating it. Some may not know how to. Others may be uncomfortable doing so or forget to. Some may calculate it incorrectly. Disclosure of the figure ensures that everyone has easy access to the right figure.

It also helps data aggregators compile valuation statistics. This enhances efficiency in capital markets the same way that Kelly Blue Book improves efficiency in the car market and home listing data improves efficiency in the real estate market. That is, a disclosure requirement facilitates the generation of comparable data sets or “comps”—about the market.

Investment professionals have better, albeit imperfect, access to this data via their network and fee-based research services, but many angel investors and virtually all public investors don’t have it. That’s not the hallmark of an open market.

An investor who knows the valuation of comparable companies is in much better position to ask questions such as these.

- *ABC is similar to XYZ Company, which was valued at $30 million recently. What makes ABC worth more?*
- *Companies at ABC’s stage of development have averaged valuations that are significantly different from others in this space —is there a reason?*
- *ABC’s valuation is half that of a comparable company that is backed by some major VCs. Given that ABC doesn’t have similar support, shouldn’t its valuation be even lower?*

Questions such as these would be easier for angel investors in a private offering, easier for average investors to formulate for a public offering, if valuation comps were readily available.

Easily accessed valuation information sets set the stage for issuers to compete for investors, much as merchants do for customers. Some will view this is as undignified, but this is a characteristic of fair markets. And competition should result in better deal terms and lower valuations. It should also help investors make better decisions. And, it will benefit companies who offer a better deal because more investors will recognize when one is offered. All of this should good for the economy, good for investors and good for competitive companies.

The lack of a disclosure requirement has two negative consequences. First, investors are more likely invest unwisely. Second, issuers who offer better terms are less likely to create greater demand if investors who do not understand the importance of valuation.

I have met accredited investors who are uncomfortable calculating valuation. I am certain that many average investors would struggle if asked to do so. Some believe, mistakenly, that the SEC must assess an issuer’s valuation before an IPO takes place. It doesn’t. The commission assesses whether an issuer complies with the disclosure requirements—which does not include valuation.

Because the SEC does not evaluate an issuer's valuation, it tells investors, effectively, *caveat emptor* (buyer beware).[178] And this is understandable, for there is no reliable way to assess valuation and besides, in a market economy, prices are set in the market.

Even in a market economy, many believe government should move markets to be more transparent and competitive. But when it comes to valuation disclosure it hasn't, not in America anyway, the largest capital market in the world. That is something, Dear Reader, I hope to enlist your support to change, as you'll shortly see.

Skeptics of this idea might consider the likelihood that more money has been lost by more investors because they overpaid for a stock than has been lost due to fraud, which is a focus of regulatory attention. Investors who are not valuation aware are more susceptible to "irrational exuberance." Also, that entrepreneurs can be hurt by valuation-unaware investors for success at raising capital at excessive valuations encourages arrogance about OPM—Other People's Money—and/or naïveté about future raises of capital. Furthermore, companies that offer a low valuation will be met with blank looks from investors who are unsure what it means, which contributes to inefficiency.

It will take far longer for valuation disclosure to happen without government. Attorneys will advise issuers to not disclose their own because it is not required, and disgruntled investors may later argue the company represented itself as being "worth" the valuation. An undaunted CEO will find the task more complex than providing the figure because the prospectus will also need to explain what valuation is. The following concept formula summarizes why a government requirement is needed.

No General Requirement to Disclose Valuation	=	Lack of Context for Voluntary Disclosures that are Made	→	A Long Time Before Market Forces Lead to Voluntary Disclosures

Without valuation transparency, the market for equity capital is far less efficient than many other markets. Grocery stores offer an analogy. Unit pricing helps shoppers evaluate and compare products. Where it's not present, shoppers must calculate price per pound, per ounce, etc. Some maybe too busy or uncomfortable to do so. Before it was adopted, food companies competed by promoting awareness of their brand and offering attractive packaging. In markets where unit pricing was adopted, competition shifted toward value as defined by price.

Nutritional Fact Panels take the food analogy further. The disclosure of fiber, salt, sugar, fat and calories in a serving encourages informed shopping, and, it encourages manufacturers to offer healthier products. It also helps small companies compete against large ones with established brands, better aisle placement and fancier packaging.

Similar dynamics are possible in equity securities. Issuers who are not marketed by Wall Street banks have a better prospect of competing for investors on valuation if all investors have ready access to an issuer's valuation and data about the comparable companies.

[178] Some states use their Blue Sky laws to evaluate an issuer's valuation, but, they lack authority over offerings that are registered with the SEC.

Two things seem true. Implementation of the JOBS Act will encourage more companies to offer stock to a larger pool of valuation-unaware investors, and, markets enhance the quality of products when relevant information is readily available to buyers.

Valuation disclosure may sound esoteric, but it's not. The SEC requires issuers to disclose risk factors in offering documents. Sometimes, the result is pages of eye-glazing prose.

A requirement for valuation disclosure could be accomplished on one page.

In and of itself, the figure would not necessarily mean much. As discussed in chapter fourteen, it is a challenge for anyone to evaluate a valuation. But one can't contemplate something unless they know what it is and engage in discussion with others attempting to evaluate it

At a micro level, valuation disclosure makes it easier to ensure that investors and companies consider an important data point that heretofore has been in the closet.

At a higher level, it encourages market forces to work in the capital markets the way they do in most markets—it promotes competition for buyers. A consequence of this would be better informed investors.

A friend bemoaned to me that his son, had changed his college major from computer science to existential philosophy.

"What do they do all day?" he asked rhetorically, "Sit around asking, How high is up?"

Philosophers of all stripes will be among those who debate valuations…once they know what the universe of possibility is.

At an existential level, it promotes thinking about what constitutes value and how uncertainty is distributed.

All of this would help market forces improve how capitalism works regardless of whether the Fairshare Model is

"Take the two popular words today, 'information' and 'communication.'
They are often used interchangeably, but they signify quite different things.
Information is giving out; communication is getting through."
-- Sydney J. Harris

The single biggest problem in communication is the illusion that it has taken place.

--Anonymous

Both quotes provided by Dr. Mardy Grothe

What Valuation Disclosure Might Look Like

What might a SEC valuation disclosure requirement look like? Before issuing new rules, the commission calls for public comments—respondents on this subject would have an array of views. Like many things, the more one seeks to define rules to apply a concept, the more complicated it can appear. But it is possible to craft an approach for most situations and ways to deal with those less straight-forward.

What kind of offerings should be covered? To generate useful data, it should be required for *all equity offerings*. That is, for both private (e.g., Reg D offerings) and public offerings of stock (e.g., Reg A, S-1 offerings, etc.). There is another reason to include private offerings—some angel investors are uncomfortable calculating it—just because they are rich enough to invest doesn't mean they know how to calculate it. So, it makes sense to require it for all stock offerings, even private offerings. The costs are miniscule and the potential benefits are large.[179] There is an argument to be made that the valuation private investors place a private company should not be public, but private companies have long been required to inform securities regulators when they sell stock.

Where should the disclosure appear in a prospectus? On the front page, where the price per share is displayed and in the section that summarizes key aspects of the offering. In both these areas the pre-money valuation should be stated.

What would the disclosure say? Something like the following:

> *Based on the terms of the offering, we (the issuer) have given our company a valuation of $XXX. This is calculated by multiplying the shares outstanding at the time of the offering by the offering price per share.*

This would cover most equity offerings, but not all. Some issuers may want to define their valuation differently. For example, there may be restricted shares outstanding that the issuer believes should be excluded from a valuation calculation. That is certainly the case for an issuer that uses the Fairshare Model. It will want to calculate it based on the shares of Investor Stock outstanding and exclude the Performance Stock (explanation in chapter twelve).

Any issuer ought to have an opportunity to offer a valuation that is calculated differently, provided explanation makes sense to the securities examiner. If there is disagreement on this point, an issuer ought to be able to provide an alternative figure in addition to the one the regulator requires. The standard for deciding such matters would emerge from the SEC's rule making process.

A far reaching idea for public offerings is to disclose the valuation trend in recent years, focusing on significant financing events. Private companies often provide this to VC and PE investors that are considering an investment. One could argue it makes sense to disclose an IPO prospectus, if the goal is to provide public venture capitalists (i.e., public investors who buy new stock from a venture-stage company) with data that private venture capitalists have.

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[179] Beginning in 2009, the SEC has been rolling out a requirement that companies use a technology called XBRL in their regulatory filings that makes it easier for readers to find, extract and analyze data. Valuation disclosure follows that spirit as well as that of the so-called FINTECH movement, a term that come to be applied to innovation in financial services (e.g. PayPal, Bitcoin, mobile payment systems, Big Data and predictive modeling).

What Disclosure of the Basis for the Valuation Might Look Like

A strong case can be made for valuation disclosure. Should there be a requirement for an issuer to discuss how it arrived at the figure? I think it should be encouraged to discuss the basis for a valuation but not necessarily required to do so. Why? If a company's management doesn't want to talk about its valuation, they will say something like this:

> *The initial public offering price of our common stock was determined through negotiations between us and our underwriters.*

If valuation must be disclosed, many issuers want to say something about it, if only to make the figure seem reasonable. The following is an example of a more informative explanation:

> *We estimate the fair value of our common stock using a discounted cash flow model and in consideration of the following factors:*
>
> - *the market value of comparable companies;*
> - *our historical results and forecasted profitability;*
> - *our market and liquidation value of our assets; and*
> - *market and economic conditions that are expected to affect our industry*

Those who say something about how they chose their valuation may struggle because just as it's a challenge for an investor to evaluate, it is a challenge for companies to set. Here are the Top Ten more candid explanations (i.e., not written by a lawyer) that one might see:

Top Ten Explanations for a Valuation You MIGHT See

10. We applied a multiple of 2.3X to our projected revenue for next year.

9. We applied a multiple of 8X to our projected income in three years.

8. We need $10 million and our founders want 55% of the company, so that works out to a valuation of $8.2 million.

7. A valuation expert assessed our projections and risk factors, then used a sophisticated model to set a valuation range; we selected the mid-point.

6. We expect to be worth $40 million within 3 years, so we valued the company at $10 million to offer an attractive deal.

5. Our management team is worth it.

4. We created a five-year income projection and assumed a constant growth rate thereafter. To this, we applied a cost of capital of 18 percent to arrive at the present value of our company.

3. We met with lots of smart people and came up with a figure that made sense to everyone.

2. Firms in Silicon Valley and New York City are reportedly being valued at $500 million—we're based in the Midwest, so we decided to offer a discount.

1. Our principal competitor has a $500 million valuation. They have 20 times more customers than we do but our product is better, so we should be valued at a premium.[180]

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[180] Inspired by http://recode.net/2015/04/29/domos-josh-james-defends-his-2-billion-valuation-full-video/

For fun, here are some explanations an issuer may have for a valuation that you'll never see in an offering document, especially one reviewed by an issuer's attorney.

Top 10 Valuation Explanations for a Valuation You Will NOT See

10. Beer pong

9. Our potential market $6 billion in size; we're a bargain at 1 percent of that.

8. VC backed companies are getting that.

7. Consensus figure from our Ayn Rand book club.

6. (Number of founders X $5 million) + (number of engineers X $2 million)

5. We want to create news.

4. Our business model is disruptive.

3. We intend to be the top player in our space

2. We applied a multiple to our projected loss, then changed the negative sign to a positive.

1. If all goes right, it's reasonable!

Valuation Disclosure – Why Hasn't It Happened Already?

Why doesn't a prospectus say "our valuation is X% lower than comparable companies"? Because it would be confusing to readers who have little idea about what the number means or how to evaluate it. Legal counsel will advise issuers to not disclose valuation in offering documents because it is not required. Plus, if it is disclosed voluntarily, disgruntled investors may argue that the company represented itself as being "worth" the valuation.

So, issuers don't compete for public investors by offering better terms. Is this market-driven capitalism? Or, is it something else, a self-serving arrangement among those in positions of influence?

When you think about it, this stands in extraordinary contrast to most markets; sellers normally offer deals to attract buyers. Why is price-based competition prevalent in virtually every market but not in public equity? Is this a demonstration of free market economics? Or, is it example of a rigged market? Or, something in between a free and rigged market?

For competition to happen, buyers (investors) must know what the price is, the valuation in this case. When you break it down from the perspective of the players involved, it makes sense that market forces don't result in valuation disclosure. Issuers with Wall Street IPOs don't need to compete on this basis. Their agents, the investment bankers and broker-dealers that they engage, see no advantage in making the valuation clear to the public. In fact, they reap a benefit when it isn't disclosed. An IPO is considered a success when there is a "pop" from the offering price to where the stock trades in secondary market. A jump in share price translates into happy clients—the investors who agreed to buy shares at the offering price. Such investors often "flip" or quickly sell their shares to those who lack the wealth or influence needed to get an allocation of shares at the IPO price.

Fundamentally, I think issuers don't compete for public investors because these investors are not a market force. They are not in a position to shape outcomes. Rather, they are the target of market forces; at the bottom of the financial market food chain. They are the buyers who are eager to invest in venture-stage companies but haven't been allowed to do it at earlier stages—so, they compete amongst themselves to get the shares, bidding the price up in the secondary market.

When market forces don't promote competition, government has an opportunity to encourage competition via regulation. Why hasn't government stepped in to require the disclosure that the market hasn't? I have theories that involve the congress and the SEC.

At the congressional level, many politicians raise campaign money from the financial services lobby. The CBS news magazine *60 Minutes* reported that a number of them have become "very, very wealthy" in office as a result of their ability to astutely trade stocks or to gain access to desirable IPO allocations.[181] Legislators who are otherwise inclined to be consumer oriented may not have much interest in the capital markets; they may be more likely to oppose small investor involvement than to find ways to make it more competitive.

At the regulatory agency level, I suspect the SEC hasn't required valuation disclosure because the financial services industry is certain to discourage it and there is no political outcry for it. Since the agency

[181] "Insiders: The Road to the Stock Act" report, CBS News program *60 Minutes*, aired Jan. 17, 2012, http://www.cbsnews.com/news/insiders-the-road-to-the-stock-act/

is wholly dependent on the Congress for its annual appropriations, this is a recipe for inaction on valuation disclosure. In March 2012, former SEC chairman Arthur Levitt interviewed the then-current chairman of the SEC, Mary Schapiro, on his radio show. Concluding a discussion about the failure of the Congress to approve "self-funding" for the SEC, Mr. Levitt said the following.

> *I guess I can afford to be more cynical now, Mary. I think that the reason you didn't get self-funding was because Congress didn't want to give up the appropriation power over the agency. Because historically, it's 'self-funding' for them in terms of campaign contributions. I can say it now. You probably can't.*[182]

If the SEC were self-funded it would be able to use money that it collects in fees, fines and legal settlements to cover its budget. Self-funded financial regulatory agencies include the Federal Reserve, The Federal Deposit Insurance Corp. and the Office of the Comptroller of Currency. The only two that are not are the SEC and the Commodities Futures Trading Commission (CFTC). Among the influential groups in favor of self-funding for them is the Systemic Risk Council, whose members include former SEC Chairman William Donaldson and former CFTC Chair Brooksley Born. They argue that the difference between self-funding and the Congressional appropriations process is "enormous."

> ***Self-funding** helps agencies hire and retain good staff and **insulates them from political pressure exerted by the deep-pocketed institutions they regulate**. It also allows them to make and implement strategic decisions to adapt to changing markets and build needed information technology to become more effective and efficient, all which require multiyear budget certainty. The SEC and CFTC have none of these advantages.*[183] [Bold added for emphasis]

Of course, it may also be that the SEC staff just doesn't see this as an issue, even though the agency's motto is "The investor's advocate." After all, all that an investor needs to do is to pull two numbers out of the document and multiply them, something that would be obvious to those who work at the commission. But, this logic is inconsistent with the lessons learned from unit pricing in grocery stores, which also requires a simple calculation that many shoppers are too uncomfortable or busy to make; it empowers buyers to make wiser choices and encourages competition that benefits consumers.

[182] "A Closer Look With Arthur Levitt: SEC's Mary Schapiro (Audio)", Mar. 23, 2012, Bloomberg, http://media.bloomberg.com/bb/avfile/vlbmyA3v.W0A.mp3 Check out Levitt's interviews with other business and political leaders here https://www.bloomberg.com/feed/podcast/closer-look.xml

[183] "SEC: Self-Funding vs. Congressional Appropriations, by Dunstan Prial, Fox Business, May 17, 2013 http://www.foxbusiness.com/economy/2013/05/16/sec-self-funding-vs-congressional-appropriations/

A Call for Action on Your Part

I close out this section on valuation with a call for action by you, Dear Reader. If you want to see market forces work for public investors, you and other like-minded people have to do some things. In chapter one, I wrote the following:

> *Changes to the The-Way-Things-Are-Now always have challenges. It has been observed that change occurs when the pain associated with doing things differently is less than the pain of continuing to do it the way it's been done. That suggests that public investors should channel Howard Beale—they should make their discontent known.*

Recall that Howard Beale is a character in the movie *Network.* The news anchor who exhorts his viewers to go to their windows and yell out *I'm as mad as hell, and I'm not going to take this anymore!*

I now ask that you channel your inner Howard Beale, then, in polite language, send the SEC chairman[184] a message that conveys your support for a valuation disclosure requirement. If enough people do this, the matter will capture the attention of the SEC staff. A simple message like this will suffice:

> *Dear SEC Chairman,*
>
> *I understand that the SEC does not require issuers of equity securities to make prominent disclosure in offering documents of the valuation that they give themselves. I urge you to change this. I hope the commission will make the following a required disclosure for both private and public offerings:*
>
> - *The pre-money valuation on the cover page and other prominent places; and;*
> - *Discussion of the factors management considered when setting the valuation;*
>
> *I support initiatives that encourage market forces to improve investor protections. If the SEC requires such disclosure, more companies may compete for investors by offering lower valuations and other favorable terms.*
>
> *Sincerely,*
>
> *[Your name and address]*

The commission provides this email address chairmanoffice@sec.gov for communications to the Office of the Chairman. The postal mail address is:

Office of the Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

[184] The current chair of the agency is a woman, Mary Jo White, as was her predecessor. It is an acceptable practice to address her as "chairman" or her position as the "office of the chairman".

Then, send your congressional representative and senators a similar message. Since 2016 is a presidential election year, those running for office are likely to pay attention. If you can speak to a candidate for federal office, ask them to support a valuation disclosure requirement.

Use social media to create awareness of the valuation disclosure movement.

If you live outside the U.S., take similar action in your country. Equity crowdfunding is further along in the Canada and Europe, so other countries may adopt valuation disclosure rules before it happens in America.

Over time, valuation disclosure will encourage market forces to benefit non-professional investors. It will also create conditions that shorten the time it takes for the Fairshare Model to emerge as popular alternative for companies that raise venture-stage via a public offering (see the end of chapter six for perspective on how long it might take for this to happen).

Why valuation disclosure WILL HAPPEN

1. It is is the right thing to do.
2. The cost to implement is trivial.
3. Popular support becomes visible enough to policy makers that it counteracts the reasons that it will not happen. In particular, the #1 for why it will NOT happen (below).

Why valuation disclosure WILL NOT HAPPEN

1. It is not in the interests of the most powerful players in the influential investment banking, venture capital and private equity community.
2. Policy makers, possibly influenced by the preceding reason, don't perceive the absence of disclosure as a big problem—after all, anyone can calculate it.
3. Advocates of valuation disclosure lack the financial resources to lobby policy makers.
4. Those who can benefit from valuation disclosure have a weak understanding of what valuation signifies.

Onward

This closes out section III. The next section, the final one, addresses fraud, failure and a mélange of topics

Section IV: How Investors Lose Money—Fraud, Overpayment & Failure

Entrepreneurs and those most interested in seeing them succeed tend to view the prospect of less expensive and burdensome requirements to raise capital from public investors as an angelic development.

But the very idea sends shudders down the spines of some policy makers, regulators and opinion leaders. They see a potential demon that will bring harm to the wee villagers (i.e., average investors).

This section considers the objections to making it easier and less expensive for venture-stage companies, especially start-ups, to sell stock to average investors.

As a rule, such companies raise capital via a private offering, the kind available only to accredited investors. But the JOBS Act has made it more likely that some of them will elect to do this using a public offering. The objections to this liberalization of securities laws are vaguely sensed in some respects but center on fear of fraud and a belief that it is too difficult for average investors to make money in these types of investments.

The overarching question this book poses is, “Is there significant investor interest in seeing such offerings use the Fairshare Model, as opposed to a conventional capital structure?”

The following chapters discuss concerns about making it easier for average investors to participate regardless of what capital structure is used because such investments are high-risk.

Chapters in this section are:

- Chapter 16: Causes of Investor Loss: Fraud, Overpayment & Failure
- Chapter 17: Failure
- Chapter 18: Other Objections to Public Venture Capital

Chapter 16: Causes of Investor Loss: Fraud, Overpayment & Failure

Preview

- Foreword
- The Anxiety
- Disclosure and Merit Review
- How investors lose money
- Unpacking Fraud
    - Fraud before the IPO
    - Fraud when IPO investors invest
    - Fraud after the IPO
    - Fear of potential fraud vs. punishment of actual fraud
- Closing thoughts on fraud
- Investors overpay
- Failure
    - A prosecutor's thoughts on failure (and the Good Life)
- Onward

Foreword

The demon on the preceding page symbolizes investor loss writ large because it is feared. However, the main reason is that we associate demons with darkness and shadows, where it is difficult to assess them clearly. So, our sense of them can be exaggerated. Would they evoke the same degree of fear if you could see the demon was just a foot tall or could be dispatched with a kick?

There are a variety of ways that loss can happen. Fraud, overpayment and failure are the focus of this chapter because they are most often used to describe the demon. The cause of loss in a given circumstance could be one or a blend of these three.[185]

In order to help you place these causes of investor loss in perspective, this chapter considers each of them. I will suggest that fear of fraud in a venture offering is overblown and that more significant causes of loss are overpaying for an investment and failure. And, as you already know, the Fairshare Model is a way to deal with overpayment. So, if fear of fraud is exaggerated and overpayment can be kicked somewhere, we need only fear failure itself, which leads to an interesting discussion.

Before getting to these three causes of investor loss, we'll consider the anxiety that surrounds efforts to make it easier and less expensive for start-ups to sell stock to public investors and the two different approaches securities regulators use to protect investors—disclosure and merit review.

[185] There are other causes of loss such as macro-economic conditions, market manipulation and the fact that thinly traded stocks have poor liquidity.

The Anxiety

Is the JOBS Act a liberalization of securities law that will stimulate economic growth and job creation, or, is it a weakening of securities regulations that will harm more average investors than it helps? It will take years to figure that out, but there are a number of thoughtful people who fear its consequences. One of them is Steven Rattner. He is a Wall Street financier who led the Obama administration's *Task Force on the Auto Industry* that restructured the U.S. auto industry. He wrote the following in an op-ed piece *A Sneaky Way to Deregulate*.

> *Slapping a catchy acronym like the JOBS Act on a piece of legislation makes it more difficult for politicians to oppose it — and indeed that's what happened with the Jumpstart Our Business Startups Act. Its enticing acronym notwithstanding, the JOBS Act has little to do with employment; it's a hodgepodge of provisions that together constitute the greatest loosening of securities regulation in modern history.*
>
> *Most troublesome is the legalization of "crowd funding," the ability of start-up companies to raise capital from small investors on the Internet. As soon as regulations required to implement the new rules are completed, people who invest money in start-ups through sites similar to Kickstarter will be able to receive a financial interest in the soliciting company, much like buying shares on the stock exchange. But the enterprises soliciting these funds will hardly be big corporations like Wal-Mart or Exxon; they will be small start-ups with no track records.*
>
> *Picking winners among the many young companies seeking money is a tough business, even for the most sophisticated investors. Indeed, most professionally run venture funds lose money. For individuals, it's pure folly. Buy a lottery ticket instead. Your chance of winning is likely to be higher. Supporters say the amounts that can be lost will be limited. But an American earning $40,000 can still risk $2,000 per year.*
>
> *To be sure, the Sarbanes-Oxley securities regulation law has overly burdened public companies and deterred initial public offerings. But the JOBS Act's update for "emerging growth companies" goes too far. Although 25 Democratic senators and one independent, Bernie Sanders, opposed the legislation, it had broad support from business groups and from some research organizations like the Kauffman Foundation. The Obama administration signed on, convinced that the need to encourage start-up capital was great and that the legislation's shortcomings could be fixed during the implementation phase.*
>
> *The largest number of jobs likely to be created by the JOBS Act will be for lawyers needed to clean up the mess that it will create.*[186]

I wholeheartedly agree with Rattner that it is tough for anyone to pick a winning start-up.

I'll add, however, that lottery tickets have odds that are far worse than a stock. Plus, a loss on a stock is tax-deductible but one on lottery tickets is not. Also, that the largest purveyors of lottery tickets are affiliated with government.

But, I digress.

[186] "A Sneaky Way to Deregulate", by Steven Rattner, New York Times, Mar. 3, 2013, **http://nyti.ms/YO1zic**

The point I wish to make is that there is anxiety about making it easier for a risky class of companies to sell stock to average investors. There are good reasons for it but there are also good reasons to experiment in this space. After all, these types of companies represent the engine for economic growth, job creation and innovation. So, while I share concerns with critics of the JOBS Act, I hope that they participate in looking for ways to make this type of investing less hazardous for public investors. Surely, an agreeable way to start is to support a valuation disclosure requirement!

My appreciation of this anxiety is enhanced by my experience with Fairshare, Inc., the company that I co-founded in the 90s to be an online platform for investor education and interaction.[187] We declared our goal at the start of our membership drive: a large enough membership to attract companies with direct public offerings. We would let them pitch our members for free if they used the Fairshare Model, passed the due diligence of our members and allowed them to invest as little as $100. We would be commission-free and would not handle any money or stock; an investor-oriented market for DPOs.

Fairshare offered free and paid memberships. We said that we could not promise that paid members would get more privileges than a free member and that we were unsure if our plan would work. To solicit feedback, I alerted the SEC and a number of state regulators that portions of our business plan was on our website. With one exception, the agencies we interacted with expressed concern but gave us an opportunity to address them; the California regulatory agency ordered us to cease and desist from offering memberships to California residents.

The response from the California Department of Corporations was striking for three reasons. First, it was premature; we said that it could take years to have offerings to present, so, the state outlawed our product while it was in research and development. Second, it was severe; other states engaged us in discussion but California elected for the harshest possible response. Third, California applied unique legal reasoning. It found that a membership was an investment contract; this idea was rejected by regulators from other states and the SEC. Not only that, California said that a free membership was a contract![188]

So, California's enforcement hammer was premature, severe and relied on novel reasoning. Its regulators were alarmed enough by what Fairshare hoped to do that they decided to act before it was offered. They sensed a demon and quickly exercised the maximum enforcement action available.

Fast forward nearly eighteen years. The JOBS Act is law and new rules have been issued by the SEC that alter the landscape of securities regulation. At the same time, the California Department of Corporations lists its order against Fairshare as precedent setting (i.e., it indicates how it will act now). I see it is as a manifestation of anxiety, expressed in this conceptual equation.

(Internet + Venture capital + Average Investors) = Something Bad

Steven Rattner and others might formulate the anxiety this way:

Public Venture Capital = (Hard To Succeed At + Vulnerable to Fraud) = Imprudent

Frankly, the sentiments in these equations reflect the view of many thoughtful people.

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[187] The history of Fairshare is described at length in chapter six.

[188] To form a contract, the law generally requires that consideration—money or a promise—must be exchanged. It is extraordinary to find that a contract can be formed without consideration.

Disclosure and Merit Review

By "government," I mean any level of it and self-regulated organizations like the Financial Industry Regulatory Authority (FINRA).

Before addressing how average investors lose money in venture-stage investing—the demon—let's discuss some of the ways that government tries to protect investors. Here is what Arthur Levitt, former chair of the U.S. Securities and Exchange Commission, said about the ability of regulators to prevent fraud, the "hair on fire" fear.

> *I don't know of any government agency, any U.S. attorney office [or] any district attorney that has been able to uncover a fraud until the fraud is perpetrated. So, the notion that the SEC is going to be there before the fraud happens is, I think, ridiculous*.[189]

That said, securities regulation has broad anti-fraud provisions and government dedicates significant resources to enforcing it. As a result, the response to fraud is more robust when it involves securities than when it doesn't. To prevent it, government relies on three basic strategies.

1. Help investors learn how to recognize and avoid questionable investments.
2. Deter offerings that appears to be suspicious from being sold.
3. Investigate, prosecute and punish wrongdoers, which deters others from acting similarly.

The how and why of the first and third strategy is apparent. Not so for the second, because it is less visible. There are two approaches to deter suspicious offerings from being sold.

One is to assess whether an issuer's disclosures are full and fair. If a regulator suspects that important information is withheld, incomplete or misleading, the review process takes longer and become more expensive, sometimes leading an issuer to withdraw its effort. Ultimately, government seeks to ensure that the offering document has the information investors need to assess an investment, but leaves it to investors to evaluate the quality of the investment. As mentioned earlier, former regulator told me the premise; "You can sell stock in a dead horse, so long as you disclose that the horse is dead." The SEC and about twenty states use the disclosure standard.

The other approach is a merit review, where government determines whether an offering is suitable for investors. It is used by about thirty states and how it is applied varies, sometimes considerably. If a merit review state finds that an offering is too risky for average investors, it denies registration, which means it cannot be legally sold to investors who reside there.

For an issuer's perspective, having multiple standards for suitability applied by a different sets of regulators is vexing. It drags out the process and significantly increases the cost of capital—it is a form of inefficiency that the JOBS Act sought to reduce.

[189] Mar. 23, 2012, A Closer Look With Arthur Levitt radio show, http://www.voicebase.com/autonotes/public_detail/95869/refine/chairman

Philip A. Feigin is a former Colorado Securities Commissioner who has led the National Association of Securities Administrators Association, an organization of state regulators. NASAA has a history of promoting uniformity in state securities laws, which are commonly referred to as blue sky laws. Feigin describes merit review this way:

Merit review was the heart and soul of the original "blue sky" laws, the authority of state securities administrators to deny securities registration to an offering that, in the administrator's view, was "unfair, unjust or inequitable" to, or would "tend to work a fraud" on investors. At its height in the '70s and '80s, about 36 states applied merit review standards to new offerings already reviewed for disclosure by the SEC. While laudable in intention, making decisions based on those standards proved challenging to enforce and defend over the years.

The goals of merit review are among the most misunderstood in American finance, by critics and perhaps state regulators both. Merit standards are intended to make an investment "fair" to the investor. It is not intended to be a predictor of profitability.

Two classic examples of merit guidelines relate to repayment of principal loans and "cheap stock." Merit states place tight restrictions on issuers using investors' money, offering proceeds, to pay off prior loans made to the company by its principals. Instead, offering proceeds must be applied to the company's operations. Also under merit review, company insiders are required to place some or all of their promoters' shares a/k/a "cheap stock" (shares they received from the company for nothing or at a price much lower than the price investors will pay for the registered shares) in escrow until such time as the overall value of the company has increased in an amount proportional to that "cheap stock"/public price differential. [190]

Besides insider loans and cheap stock, some merit review states consider an issuer's ability to pay fixed charges on debt without the IPO proceeds and whether the new stock's voting rights are inferior to that already issued.

Notwithstanding Feigin's statement that a merit review should not be an attempt to assess future profitability, states have been known to deny registration for a public offering because little revenue has been generated, the prospect for near-term profitability is poor and/or the valuation is excessive relative to its tangible book value, earnings per share and/or financial condition.[191]

When you think about it, such qualities characterize virtually all venture-stage companies, which led securities attorney Samuel S. Guzak to make the following statement.

In 1980 the Apple Computer IPO became the poster child for what was wrong with allowing an additional layer of so called state "Blue Sky" review. Massachusetts and more than a dozen other states barred non-institutional investors from participating in this IPO, viewing it as another "hot" IPO – too hot for the ordinary investor.[192]

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[190] SEC's New Regulation A+ and the States' M Word (Merit Review); by Philip A. Feigin, *The National Law Review*, Mar. 26, 2015. http://www.natlawreview.com/article/sec-s-new-regulation-and-states-m-word-merit-review
[191] https://www.sec.gov/news/studies/uniformy.htm
[192] "The SEC on Regulation A+", by Samuel S. Guzak, June 24, 2015, http://corporatesecuritieslawyerblog.com

If legislation has a musical rhythm then, surely, the beat of the JOBS Act is to improve entrepreneurial access to capital and reduce its cost. Making securities regulations (more) uniform would help, but that is not what the JOBS Act does. To explain, a brief technical detour is called for.

When federal securities laws were created in the 1930s, the states agreed to allow their authority over a securities offering sold in their state to be preempted by the new federal agency, the Securities and Exchange Commission, if it was for a "covered security." A covered security is one that will trade on a SEC approved exchange (e.g., NYSE, NASDAQ). The idea being that if an issuer meets the financial and other criteria of such an exchange (i.e., total assets, market capitalization, number of shareholders), for the sake of efficiency, the offering need only reviewed and registered with the SEC.[193]

If a new stock is *not a covered security,* states evaluate the offering before it may be sold in their state. A disclosure state will seek to determine if the issuer's disclosures are adequate—from a practical perspective, they rely on the SEC to do this. A merit review state will do this too, but also evaluate whether the offering is fair to investors. The criteria applied varies by state.

The very first regulation issued by the SEC was an exemption from registration of an offering and it was named, logically, Regulation A or "Reg. A" for short. Sam Guzak explains that "it allowed small companies to sell their shares to the general public through an abbreviated SEC registration and review process which even dispensed with the need for audited financial statements and with no ongoing reporting obligations."[194] In contrast, a covered security calls for audited statements and has ongoing reporting requirements (e.g., quarterly and annual filings, etc.). Guzak continues "the 50 states retained their ability to require these same companies to file their offering materials in their states – becoming subject to a multiple layers of regulatory review. And unlike an SEC review, which focuses only on assuring full disclosure to investors, the states retained the unfettered discretion to bar the offering in their respective states if it deemed the offering unsuitable for its residents or otherwise too risky."

Much of the excitement about the JOBS Act centers on changes it authorizes to Reg. A, now known as Reg. A+, which now has two forms, Tier 1 and Tier 2. Each tier requires SEC review (i.e., the disclosure standard) and each results in tradable stock that can be sold to any investor. A Tier 1 offering can be used to raise up to $20 million without an SEC requirement for audited financial statements. Such an offering is subject to state review, however, and a merit state may require audited financials. In states where this is the case, Tier 1 issuers will not be allowed to sell stock. A Tier 2 offering can be used to raise up to $50 million and does not require state review but it does require audited financials.

The SEC's rules to implement Reg. A+ became effective June 2015. Over time, these offerings will provide a laboratory for experiments on how to balance the opportunity to unaccredited investors and small companies against the concern about fraud. This is particularly true for Tier 1 offerings, which do allow state review. Disclosure states will rely on investors to make prudent decisions. Merit states will add the judgment of their regulators on what is fair or prudent.

It will not be a clean comparison though. A company with audited financials can avoid merit reviews with a Tier 2 offering. This means merit review states could see offerings that they would object to as a Tier 1 offering sold in their state anyway.

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[193] http://www.investopedia.com/exam-guide/series-63/securities/federal-covered-securities.asp
[194] "The SEC on Regulation A+", by Samuel S. Guzak, June 24, 2015, http://corporatesecuritieslawyerblog.com,

How investors lose money

How do public investors lose money on a venture-stage company? Three broad possibilities come to mind.

1. Fraud;
2. Investors overpay and/or
3. Failure

The ensuing pages consider each possibility separately, but they are not mutually exclusive. An example of how they can mix is a failing company (#3) may engage in fraud (#1) in oreder to forestall collapse or benefit insiders. Another example is where investors overpay (#2) to invest in a company that eventually fails (#3), possibly because it was poorly managed or had little prospect of success. Yet another example is that a company may engage in fraud (#1) in order to persuade investors to overpay (#2) and it eventually fails (#3). Then again, such a company may not fail.

If a company is thinly traded, as virtually all small cap stocks are, there is yet another way for investors to lose money, lack of liquidity. That is, the price of a stock at the same moment in time might be, say, $2 if you are buying but $1 if you are selling. Such a wide spread between the buy and sell price is a "Roach Hotel".[195] It can be a significant contributor to investor loss, but I don't include it above because it is driven by an issuer's market, not by its behavior. Similarly, there are ways that broker-dealers engage in fraud that not at issue here because they originate in the trading market, not the business itself.

Multiple perils face investors in venture–stage companies, including valuation-related challenges. However, a powerful, fear-inducing word—*fraud!*—is frequently employed by these opponents. But I suspect that relatively few investor losses result from fraud. When an entrepreneurial team makes an effort to create value but fails, it is wrong, silly and derogatory to say that the loss is due to fraud.

It is hard to find data on the prevalence of issuer fraud, but opponents of equity crowdfunding and small cap investing routinely evoke the specter of it when making their case. This can leave the other side tongue-tied and defensive. After all, they can't credibly claim that fraud will not increase. All they can do is try to put it in context.

Opponents of this investing activity may acknowledge its broad economic benefits yet believe it should be restricted to the wealthy because they can afford a loss of investment. They feel that average investors should be blocked or strongly discouraged from engaging in it. Their motto for equity crowdfunding? *Just Say No!*

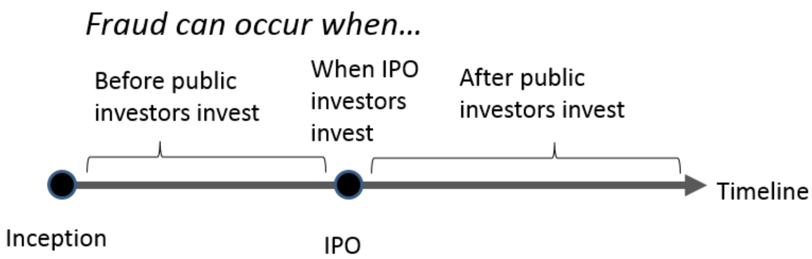
Despite these concerns, there is reason to believe that a significant number of average investors want better access to venture-stage investments and many more would like better information on valuation. It is safe to assume that all investors would like deal structures that are friendlier to them. These are propositions that this book tests.

[195] Here, "Roach Motel" appropriates the tagline of Black Flag's Roach Motel insect control device--"Roaches check in, but they don't check out." Investors who have bought thinly traded stocks (not on a major exchange) know there can be a big gap between the (bid) price to buy and the (ask) price to sell. Thinly traded stocks are more vulnerable to "pump and dump" schemes.

Unpacking Fraud

Opponents of efforts to make it easier for small companies to sell stock to average investors often center their argument on one word…*fraud!* When expressed like a shout of "*fire,*" it encourages people to associate fraud with venture-stage investments, which is unfair.

There are many ways that securities fraud can be conducted. To unpack fraud concerns about early-state companies, however, let's focus on *when* one might occur—before public investors invest, when IPO investors invest or after they invest. This can shed light on the question "Is fraud more likely when early-stage companies raise their venture capital via a public offering?"



Fraud before the IPO

It takes significant time, effort and expense to conduct a public securities offering. Arguably, anyone who intends to engage in a fraud is unlikely to form a company, then hire attorneys and accountants to help with disclosure documents.

Fraudsters have other routes that are less expensive and conspicuous; a stock offering requires disclosure, scrutiny and collaboration among people who are mindful of their reputation. An inherently corrupt group will likely want to avoid the attention.

Now, a scam could be conducted using what falsely appears to be a legal offering. The reassuring part? Compared to other scams, a stock offering can be easier for authorities to detect and investigate.

Can you tell if an offering is legal?

There is no obvious indication that an offering in compliance with securities regulations.

To determine an offering's status, an investor should contact their state's securities agency. An attorney, broker-dealer or registered investment adviser can often provide insight.

Fraud when IPO investors invest

Fraud when IPO investors invest occurs when an issuer fails to make important disclosures in a clear, honest manner. When this happens, it may be intentional deceit. Or, it may be because management is highly confident they will succeed and/or wants to minimize negative thinking. So, while fraud connotes intentionality but it can result from carelessness. Its form may be an overreaching assertion, a failure to disclose a conflict of interest, misleading data or inadequate description of risk.

Is it fraud when a company uses faulty assumptions to value itself? Seemingly not. So long as data isn't misrepresented; bad projections are not clearly fraud. Besides, issuers have an out—they routinely disclose that their valuation is arbitrary.

Fraud can occur by omission or commission. When by omission, it may be the failure to take an action that one should take. A failure to disclose important information is fraud via omission. Fraud via commission occurs when some wrong action is performed. For example, management may claim business is doing better than it is.

Companies who are the target of a fraud complaint find it expensive, time consuming and emotionally draining to respond. And even if they prevail, their ability to attract new capital may be damaged. For anyone bent on deception, there are other ways to engage in fraud that have less risk.

I have no idea how often fraud occurs in a public offering but I can point out dueling tensions on an issuer as it prepares for one. The pressure to sell the securities conflicts with the pressure to disclose why an investor should not invest. So naturally, issuers favor obtuse, boilerplate-like offering documents and rely other means to create investor interest (i.e., presentations, articles, broker-dealers).

It can be the end of the company if regulators find that the offering was fraudulent. There are anti-fraud rules that, when violated, can require a company to rescind or cancel the offering. That is, the issuer can be required to send full refund checks to all investors in the offering, not just the ones who claimed they were defrauded. If the company doesn't have the money to do this, its officers, directors and significant shareholders may have to repay the money themselves.

Then, there is also the potential for criminal charges.

The pressure to disclose appears to be a significant force to deter fraud at the time investors invest. If a company's management fabricates information or cherry-picks what to disclose, they face significant risks. If they want to perform fraud, there less conspicuous ways to do so.

Fraud after the IPO

Here are three points to consider regarding the relationship of fraud before or at the IPO to fraud after the IPO.

1. If a company intended to engage in fraud before and at the IPO, it will likely continue afterward. But, such a scenario is surely rare because there are more direct, less conspicuous ways to conduct a fraud. The anti-fraud provisions of securities law are broad and the enforcement resources are significant. Using a public offering to purposely engage in fraud makes as much sense as booking a flight from San Francisco to Los Angeles by way of Chicago. You could, but why would you?

2. There may be fraud before or at the IPO, but not afterwards because management is replaced or changes its plan.

3. A fraud at the IPO is unlikely to persist after the IPO if the fraud was unintentional. For example, if adverse development occurs that was not described in the prospectus.

   With that, what might fraud that arises after the IPO look like?[196]

   - Misreported financial results;
   - Corporate funds might be used in undisclosed ways that do not benefit shareholders (i.e., spent differently than described in the prospectus, in a manner that benefits insiders);
   - Taking an action that requires shareholder approval without getting it;
   - Insider trading.

All of these are against the law. And, there are other matters that may be violations of law that are not fraud, per se.

Fear of potential fraud vs. punishment of actual fraud

Does it make sense to have barriers that make it difficult or expensive for all entrepreneurs to raise capital out of fear that *some* of them *might* commit a fraud?

Government doesn't usually restrict activity out of fear that some will violate their responsibility in the future.[197] Rather, they pursue those suspected of actually doing something wrong.

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[196] An analysis of SEC enforcement actions for 2014 and first half of 2015 prepared by the Holland & Hart law firm is available here https://www.hollandhart.com/pdf/HH_BriansReport_R7.pdf

[197] The idea echoes *Minority Report,* a science fiction book by Philip K. Dick that was made into a 2002 movie. In it, futuristic police use psychic technology to detect who plans to commit a crime. Then, the police arrest the person before they can actually commit the crime.

Closing thoughts on fraud

In a February 2013 discussion about crowdfunding, Stanford University law school professor Joseph Grundfest, who is a former SEC Commissioner, said that a presumption in securities regulation is that if you are wealthy, you are smart—at least smart enough to evaluate an investment and protect yourself from fraud. If you are not wealthy, the presumption is that you are not smart enough to do this. He observed that, in fact, many accredited investors are not that smart and some unaccredited investors are. He offered the hypothetical of a newly-minted PhD in computer science; someone who is not an accredited investor (i.e., low income and heavy debt) but who can assess a start-up's technology. Securities law does not let him invest while it is a private company—he must wait until the company has a public offering.

There are liberal rules for selling securities to the wealthy and more restrictive ones for everyone else. In many respects, this construct has served society well. But a mélange of factors that include the Internet, a desire to improve access to capital for young companies and rising interest in entrepreneurism have created impetus liberalize securities regulation, arguably the most since they were created in the 1930s. It is unsurprising when one reflects on the cumulative magnitude of economic change that has occurred in recent decades. Still, figuring out how to accommodate these pressures while preserving and enhancing investor protections is not easy.

The shortest distance between two points is usually the fastest. Similarly, a direct measure of something is always preferable to an indirect one. Thus, a measurement of investor savviness would be better than an indirect one that doesn't measure it at all (i.e., the accredited investor definition). But government doesn't have a ready way to assess whether an investor understands an investment. So, to minimize the number of people who can be harmed by a bad choice, the accredited investor rule provides an easy solution, albeit not a reliable one. An increasing number of smart, savvy non-accredited investors want to engage in venture-stage investing, and this rule is an artifice to them.

One solution would be to modify the rules so that it is easier for private companies to sell stock to sophisticated non-accredited investors in modest amounts. Another is to lower the cost and barriers to offer such investors stock in a public offering.

Of course, absent some elusive criteria for investor competence to engage in venture-stage investing, this will create qualms for anyone interested in investor protections. So, a lowering of costs and barriers could be coupled with efforts by government to empower investors to make better decisions. My suggestion to do this is twofold:

1. Require all issuers of new stock to disclose the valuation they give themselves (see chapter 14); and
2. Allow parties who are not broker-broker dealers to facilitate public offerings so long as they don't charge a commission or handle any stock or money (see the story of Fairshare, Inc. in chapter six).

Investors overpay

Investors can lose money when they overpay for an investment. My bet is that more has been lost by more investors from overpriced IPOs than from fraud. It happens when the market price falls below the IPO in the quarters that follow. Why does this happen? The key ones are:

- Many investors are not valuation-savvy (i.e., they aren't sure what valuation is, how to calculate it or how to evaluate it).
- It is hard to tell what the valuation "should" be.
- It is difficult for investors to get valuation history for an issuer or for comparable companies.
- Market forces are weak; issuers don't compete for investors on the basis of valuation.

Earlier, Steven Rattner likened an investment in a start-up to a lottery ticket. It's a good analogy in that one is more likely to lose than win. But it is not a good analogy for pricing because it is easier to assess whether a lottery ticket is attractively priced than whether an IPO is. One can calculate the expected value of a lottery ticket by multiplying the prize by the odds of winning (lotteries disclose the odds). Compare it to competing lotteries and you have a rational way to rank their appeal.

By comparison, it is tougher to evaluate an IPO valuation because:

1. There may not be a payoff at all (i.e., indefinite odds of a prize);
2. If there is a payoff, the amount is unknown (i.e., no certain prize value); and
3. Investors don't have easy access to comparable valuations.

Equating an investment in a start-up to a lottery ticket conveys the risk but does nothing to indicate that investors can overpay. So, let's try a different analogy. Imagine that a significant percentage of new homes sold by developers regularly drop in value 10 percent or more. Would there be more attention to how the price was set? Probably. Buyers expect that a new home will hold its value, especially since they take on debt to buy it. And a home resonates in our collective psyche—a new stock is not such an investment and investors are not as sympathetic as homebuyers. Besides, the prospectus says the price is speculative! Also, an issuer of stock has a fiduciary responsibility to its pre-IPO investors that leads it to seek a high IPO valuation; they have no fiduciary responsibility to buyers. Home developers, on the other hand, arguably have a greater responsibility to offer value for the money. Plus, it is in their interest, since they have other houses to sell.

A good analogy for a new stock is hard to find; it occupies a unique space with respect to risk and price. Nonetheless, investors lose money (or opportunity for profit) when they overpay, and, public investors are the most likely to buy overvalued shares. Why? In chapter three, The Problem with a Conventional Capital Structure, I argue that weak market forces are a big reason. If they were stronger, one could expect to see issuers compete for public investors by offering a better deal.

The risk to investors of overpayment for IPO shares is reduced when a company adopts the Fairshare Model as it has incentive to offer a low valuation! [See chapter ten.]

Failure

The causes of failure are explored in depth in the next chapter. Here, I simply want to posit that failure is also a greater cause of investor loss than fraud and explore some high-level perspective on failure.

To begin, Dear Reader, please consider these three points:

1. Failure is not fraud.
2. Fraud may occur in a failing firm, but it need not.
3. Fraud may take place in a successful company, but it is less likely to be noticed.

Next, I'd like you to contemplate the relationship between innovation and failure at a macro-economic level. It is uncontroversial to suggest that societies that tolerate failure are more likely to create innovative products and services.

In chapter seven, I cite evidence of this provided by Professor Edmund Phelps in his book, *Mass Flourishing*. His research led him to conclude that societies thrive when they are economically dynamic because such dynamism spawns growth and opportunity. It can also result in bad luck—that is, failure. For me, an important takeaway from his book is the idea that participants in a dynamic economy find a sense of purpose as they attempt to innovative. That its participants find greater meaning to their lives when they endeavor to create value for themselves and society…*even when the result is failure*.[198]

In economics, "value" is routinely measured by the income it generates or the utility it provides. Ascribing a psychological benefit to unsuccessful effort is a remarkable concept in economics but it is a familiar one to philosophers and poets. Ralph Waldo Emerson said "Life is a journey, not a destination" and Lord Alfred Tennyson penned "Tis better to have loved and lost than never to have loved at all."

Phelps writes that modern beliefs, attitudes and values are the foundation for a modern or dynamic economy, and that such an economy facilitates what Aristotle, the ancient philosopher, called the *Good Life*.[199] Phelps argues that innovation is a byproduct of a dynamic economy. That the *pursuit of innovation* brings individuals and society meaning and vitality. Why? Because the pursuit encourages intellectual and moral growth, the *sine qua non* of human experience. You may recall these two conceptual equations I use to express Phelps' concept. They help us appreciate the upside of failure.

Modern Beliefs, Attitudes and Values → Modern Economy → Aristotelian concept of "The Good Life"

Aristotelian concept of *The Good Life*	**=**	**The *intellectual growth* that comes from actively engaging the world**	**+**	**The *moral growth* that comes from creating and exploring in the face of great uncertainty**

Thus, one can say that at a macro-economic level, the pursuit of innovation can contribute positive things to people and society, even when it results in failure.

[198] An academic friend of mine, Dr. Nimish Gandhi, observed that "entrepreneurs are different from most people. They don't view failure as defeat. Often, they find a way to comeback and try again."

[199] The Good Life is described in chapter seven.

Now, Dear Reader, let's zoom down to the micro-economic level. How might one assess the effects of failure there? Let's consider the question from the view of entrepreneurial teams, their suppliers, their customers and their financial backers.

- **Entrepreneurs**: Failure can be a badge of honor of sorts as it indicates a willingness to try to do something that demands sacrifice, talent, discipline, optimism and pluck. A failure may exhaust them but season them for other opportunities. Plus, they have the satisfaction that comes from having pursued something they were passionate about.
- **Other employees**: Employees of a failed enterprise will lose their jobs but can find that their experience helps them get new work and accelerates their career.
- **Suppliers**: The consequence to a supplier of a failed business can range from dire to a learning experience, much depends on whether they were properly paid.
- **Customers**: The cost of a company's failure is likely inconsequential unless the customer was reliant on it for future services.
- **Investors:** The consolation prize for investing in a failure is a tax deduction and a reminder to invest prudently and practice diversification.

This break-down presents a paradox. The *macro-economic* benefits of failure can be sensed but it is hard to see them at a *micro-economic* level. How can there be societal level benefits to failure when it is hard to identify who the particular beneficiaries are?

Surely, one explanation is that the benefits of the new businesses that succeed more than offset the cost of those that fail. But that is unsatisfying. I've met many people who experienced failure, sometimes multiple ones, without an offsetting win. As a rule, they were happy (or at least content) to have taken the risks they did. Their pursuit of the *Good Life* enriched their lives in a way that a cautious path did not. In other words, there are people do not have enough success to offset their failures and still feel satisfaction.

> *You miss 100% of the shots you don't take.*
>
> Wayne Gretsky, hockey great

Another explanation is that an entrepreneurial culture encourages people to develop skills and attitudes that increase the skill and mobility of the economy's participants. Its failures plow and prepare the ground for new efforts. The lessons learned, directly and vicariously, enable entrepreneurial teams and the investors who back them to be more skillful the next time they try to succeed.

Then too, failure is the shadow of hope, a powerful emotion. Where there is hope, failure necessarily follows. That's because building a company is hard and deciding whether to invest in one is a challenge. All participants in a venture-stage ecosystem are imbued with hope. They seek to gain advantage, to make a mark, a difference and profit. The collective hope of all these parties is the fuel of a dynamic, innovative economy.

Failure is the shadow of hope and a major cause of investor loss.[200]

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[200] In Greek mythology, Pandora's box explains the origins of human troubles. Pandora's curiosity leads her to open a box from which hardships and woes to escape and inflict themselves on humanity before she can shut it. She re-opens the box when she hears a small voice within it. Out flies Hope.

A prosecutor's thoughts on failure (and the Good Life)

Preet Bharara is the U.S. Attorney for the Southern District of New York. He is known for his prosecution of fraud and other white-collar crimes on Wall Street and of elected officials in corruption cases. In 2012, Time magazine named him one of the 100 most influential people in the world.

Below are excerpts from the commencement address he gave to the 2015 graduating class of the law school at the University of California-Berkeley.[201] They offer a fitting way to close this chapter because while his job is to prosecute fraud, he talks about failure and, without calling it that, the *Good Life*.

> *The air is inevitably thick with expectations. Expectation of what kind of mark you graduates will make on the world. But if we're being honest, there is also inevitably some trepidation also. And not just when you think about how you are going to pay back your student loans. You may be asking yourself, "Did I make the right choice? Is this the right career?"*
>
> *So let me start by offering a mildly radical suggestion. Promise yourself today that if you are not happy with your first law job, after giving it a genuine chance with genuine effort and a genuine open mind, you will move on. And do that for every job you ever hold. If you don't like your job, because of the people or the politics or the hours or the work, you can leave. You have worked too hard and invested too much to accept a long sentence in a job that you hate. I have seen in my years of practice too many people unhappy in a law job because they stayed too long, because they let inertia overwhelm their free will. Now, I'm generally not an advocate for being a quitter, but I am an advocate for being happy in your job. I believe you should grow and mature and learn and derive joy, actual joy from your work as a lawyer.*
>
> *I know at this point there are parents saying "What the hell is Preet talking about? Does he know this is a law school graduation? We just paid $160,000 for this education. What do you mean, "Don't practice law?"*
>
> *Now before you start throwing things at me, I should let you know that this happened in my own family. Not with me. My parents went through it with my brother, Vinny.*
>
> *So my brother was a trained lawyer, but after a time he was bitten by the business bug. He felt the pull towards becoming an entrepreneur, so he left the law. His first dotcom business didn't do so well, but he recovered. In 2005, he started another e-commerce venture with his best friend from high school, this time, selling of all things, diapers. So basically, my brother—remember, this is a proud Indian-American family—my brother went from being a Harlan Fiske Stone scholar at Columbia Law School to selling diapers on the Internet under the slogan—and this is true—"We're Number One in Number Two!" I have the t-shirt, it's true. [Audience laughter.] You laugh.*
>
> *My brother laughed too. Especially on the day that he sold his diaper company to Amazon for $540 million. Yes, my brother is now what plaintiff's lawyers call a "deep pocket."*
>
> *My brother, by the way, is a fairly competitive guy. This is also his way of saying, "Hey bro, I see your whole U.S. attorney thing and I raise you $540 million!"*

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201 http://www.c-span.org/video/?325961-1/preet-bharara-commencement-address-berkeley-school-law

There are reasons for America's enchantment with the tech and start-up culture, and it does not, I think, have to do only with the gargantuan profit potential, though much of it is that.

I think it also has to do with the spirit of energy and passion. It has to do, I think, also with the faith and possibility and attraction to the pioneering spirit.

Never mind that most new ventures fail. Each Silicon Valley success story can be seen as another example of the enduring example of the American Dream. And that is something very special.

But often ***I wish we had more of that optimistic and visionary spirit in our legal community and in our own legal and government institutions.*** *Because law needs risk-takers too. The law needs entrepreneurs too. The law needs dreamers too.*

And no matter what you decide to do in the law, I hope you find a way to inject some of that spirit because an idealistic lawyer can not only achieve the American Dream but open up that dream to other people.

Onward

The next chapter will consider the causes of business failure.

Chapter 17: Failure

Preview

- Foreword
- Perspective
- The real story of Silicon Valley is its tradition of failure
- The Yin-Yang of Start-ups and Turnarounds
- Causes of Failure
- External vs. Internal causes of failure
    - When is One-Man (or Woman) Rule a good idea?
- Seven habits of spectacularly unsuccessful executives
- The Start-Up Genome's take on failure
- Closing thoughts on failure
- Onward

Foreword

The last chapter identified three broad categories of loss for investors in venture-stage companies: fraud, overpaying for the investment and failure. I have nothing to add about fraud and much of this book deals with the risk of loss from overpayment. Failure, however, deserves more discussion; it is a complex and varied cause of loss.

Building a venture-stage company is one of the most difficult challenges someone can take on and working for one can be similarly demanding, regardless of one's position. Hope inspires an entrepreneurial team, its investors, customers and suppliers but the specture of failure lurks.There are many ways to fail.

Perspective

What is business failure? The answer may vary depending on whether you ask an entrepreneur, employee, creditor or investor. Not achieving goals? Loss of control? Missing a window of opportunity? Bankruptcy? There are a range of possible answers. For our discussion, Dear Reader, I'll define it as an investor loss that is due to honest failure of the business.

Failure = Investor loss due to honest failure of the business

Honest failure can be result from markets, product, competition, management, financial structure, etc. It can span things beyond management's control to those it could have foreseen or responded to more effectively.

Inadequate access to capital is clearly a factor that limits the ability of entrepreneurial companies to form and grow. But the focus here is failure to sustain operations, not failure to launch.

The real story of Silicon Valley is its tradition of failure

A chronicler of California's Silicon Valley is Michael S. Malone. In the 1980s, while at the *San Jose Mercury News,* he was one of the first reporters to regularly cover technology. His beat provided him exposure to movers and shakers and eventually led him to author several books on technology and business. Here's how he describes the role that failure has played in Silicon Valley:

> *The standard history of Silicon Valley begins in the 1930s in Frederick Terman's laboratory at Stanford—where, in the first electrical engineering program west of the Mississippi [river], Terman instilled the love of innovation in the young Bill Hewlett, Dave Packard and Russ Varian. And they in turn, upon graduation, started companies in and around Palo Alto and kicked off the electronics age.*
>
> *As the story continues, the development of the technology and the region got a further boost in 1956, when William Shockley, co-inventor of the transistor, came home to Palo Alto, gathered the best and brightest young engineers and physicists in the USA, and founded Shockley Labs. Then, because Shockley was a terrible boss, this now-disaffected group of employees—the "Traitorous Eight"—walked out and founded the mother company of modern Silicon Valley, Fairchild Semiconductor. A decade late, Fairchild itself blew up and scattered dozens of chip companies all over the area—the birth of modern Silicon Valley.*
>
> *That's the story told and retold in books, museum exhibits, documentaries, and feature films. We like it because it is so simple: from Terman to the Packard garage to Fairchild; from Intel to Apple to Netscape; then from Google to Facebook and beyond. Part of this story's appeal is that it is so neat—not to mention that it reinforces our desire for the trajectory of this tale to be ever upward, from success to even bigger success.*
>
> *But the truth is that this accepted version is full of holes. For one thing, it ignores the reality that thousands of companies in the Valley were born, made important contributions, then died—often leaving little trace. Industry veterans know that **the real story of Silicon Valley is even more about failure than success. That is the cost of entrepreneurship and living on the bleeding edge of innovation**.*[202]

Many policy makers and opinion leaders want to see more Silicon Valley like environments because they associate it with economic growth and jobs creation.[203] However, some of them resist efforts to reduce the cost of capital for venture stage companies through initiatives like equity crowdfunding.

As Malone points out, the real story behind Silicon Valley is about failure. One might say that just as you can't make an omelet without breaking some eggs, you can't create a Silicon Valley like environment without investor losses.

To be sure, such an economy can certainly happen without equity crowdfunding but blocking it reinforces the idea that venture investing should be the preserve of the wealthy. And, as chapter eight argues, one way to reduce income inequality is to make it possible for those who rely on the return on labor to earn the higher return on capital.

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[202] *Santa Clara Magazine*, spring/summer 2015, "Silicon Valley Story", by Michael S. Malone, page 17

[203] List of places with "Silicon" names https://en.wikipedia.org/wiki/List_of_places_with_%22Silicon%22_names

The Yin-Yang of Start-ups and Turnarounds

Start-ups and turnarounds are similar in ways that harken the Chinese philosophical concept of yin-yang, which seeks to "describe how seemingly opposite or contrary forces are interconnected and interdependent in the natural world; and, how they give rise to each other as they interrelate to one another."[204]

Fundamentally, both a start-up and an established business that is in a turnaround situation are in transition. One seeks growth, the other seeks to avoid disaster. If they are airplanes, one needs to clear the ground while the other needs to avoid falling crashing into it.

A start-up needs more capital than it can generate from operations and faces shifting conditions. A turnaround may need capital but it may have assets that will enable it to raise it (i.e., receivables, property); its challenge is to recognize the cause of its trouble and respond in an appropriate and timely manner. In both cases, meeting the challenges at hand require insight, honesty, courage, communication and commitment…luck can be helpful. It takes a particular personality to be drawn to these environments: just as it takes a particular person to be a firefighter or work in a hospital emergency room.

Failure is not a topic that has been widely studied—there are oodles of books about success but relatively few about failure. Makes sense—it's a downer. Besides, everyone wants to know how to succeed in their endeavors—few want hear what led to failure.

Nonetheless, prospective investors in venture-stage companies can learn a lot about how to minimize bad investments by paying attention to what others have learned about failure. In the pages that follow, we'll look at conclusions reached by some students of business failure.

As you proceed, Dear Reader, cogitate about how the Fairshare Model might affect a pubic company at risk of failure.

Might a broad distribution of Performance Stock affect management that is on the wrong track?

Might a conventional capital structure or the Fairshare Model be better suited to avoid tough times in the first place?

When a company with the Fairshare Model faces failure, how might the model affect the options that are pursued?

Would investors in a company facing failure favor the Fairshare Model or a conventional capital structure? Would a turnaround executive have a different preference?

The answers are conjecture until the Fairshare Model is used in a turnaround situation. Nonetheless, an exploration of the causes of failure will help us contemplate the answer to the first question—*Might a broad distribution of Performance Stock affect management that is on the wrong track?*

[204] Wikipedia entry for yin and yang https://en.wikipedia.org/wiki/Yin_and_yang

Causes of Failure

What causes companies to fail? In 2002, Harlan and Marjorie Platt, both professors at Northeastern University, reported that their research found that the principal causes of failure in established companies was as follows.[205]

Causes of Business Failure in Established Companies

29%	Loss of Market
24%	Management Failure
18%	Finance
13%	Other
10%	Bad Debts
6%	Competition
100%	Total

Note that the top two reasons explain more than half of the failures—loss of market and management failure. For an established firm, loss of market occurs for myriad reasons—technology, cost, design, business model, shifts in economic conditions, etc. For a start-up, loss of market is the failure of a market to develop as expected; it may not form at all, take longer to develop or be shorter lived than expected. A capital structure has no influence on loss of market risk—the Fairshare Model will not make a difference. However, it will reduce the cost to investors *writ large* of the leading cause of failure—loss of market.

To see why, draw a distinction between investors in a company and the aggregate capital that is allocated to all IPOs in a given period. The investment in companies that fail is lost no matter what. But those who invest in an IPO based on the Fairshare Model do not pay for future performance. Their buy-in valuation is a small fraction of what it would be with a conventional model. So now, think of the capital raised in venture-stage IPOs in a given year and imagine all use the Fairshare Model. Those companies and many more could be funded with the same amount of money. In this way, the Fairshare Model can reduce the macro-economic cost of failure.

Professors Platt found the second leading cause of business failure to be management failure. This refers to the failure of management to anticipate and respond to the need to change. Here, the Fairshare Model has potential to help a company avoid it. How?

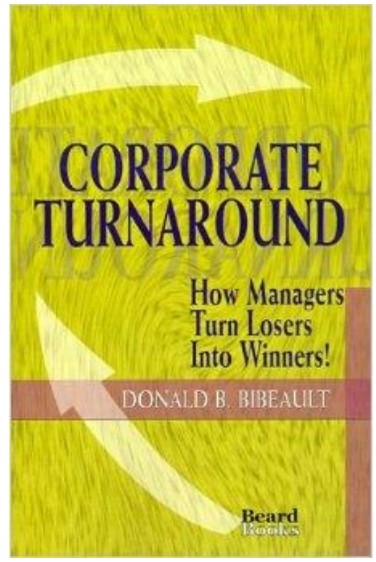
1. Management will have laser-like focus on the criteria to convert their Performance Stock. And if that criteria needs to change, say, because of market shifts, it is a safe bet that management will seek approval from the Investor Stock to update it.

2. The Fairshare Model promotes management accountability by intensifying the interest that others have in the company's success. That's true whether an issuer allocates Performance Stock narrowly, only to management, or broadly, to all employees and even suppliers. Anyone who can earn Investor Stock will be inclined to voice concern to leadership when they feel it is on the wrong track.

[205] "Understanding the Renewal Profession: Results from a Survey," by Platt, Harlan D. and Platt, Marjorie; pages 115 - 119, in Turnaround Management, A Guide to Corporate Restructuring; James E. Schrager, Editor, Institutional Investor Journals, New York, NY, 2002.

External vs. Internal causes of failure

Donald Bibeault is a particularly notable student of failure. In 1982, he literally wrote the book on how to manage a company in financial distress. His book *Corporate Turnaround: How Managers Turn Losers into Winners* emerged from his doctoral thesis at Golden Gate University. It relies on surveys, interviews of executives who had lead about 300 turnarounds, including sixteen top "turnaround artists" and other research.



Bibeault studied established companies that had been at cruising altitude for years before encountering trouble, the kind that start-ups can face as they try to climb. When asked to rank the number one characteristic displayed by turnaround managers, sixty four percent responded "growth-oriented executive" or "entrepreneur."[206] *Corporate Turnaround*, therefore, sheds light on the challenges that any venture-stage company can face.

Bibeault examined how experienced turnaround managers—those brought in to fix a failure, not the managers that they replaced—analyzed the underlying reasons for the business failure, and, whether these turnaround pros thought it was due to *external* or *internal* reasons.

So, for example, if the cause of a failure was "loss of market" he wanted to know if the market loss was due to an external factor like the economy or technology, or, if was it due to internal factors such as poor management. Thus, Bibeault teased out the difference between circumstance that was out of management's control—external factors—and the failure of management to respond to them.

It's a subtle and interesting point. Consider Lehman Brothers, the investment bank whose collapse sparked the Great Recession, for it frames the point nicely. As Charles H. Ferguson writes in his 2012 book *Predator Nation* (which was made into a revealing documentary movie, *Inside Job*), Lehman's business model "was nearly totally dependent on short-term financing."[207] In autumn 2008, as sources of short-term capital "became increasingly nervous about the collapse of the bubble, they stopped lending to banks. When its lenders stopped accepting even its AAA mortgage paper as collateral, Lehman ran out of money almost instantly."[208] Lehman sank and other businesses failed in the maelstrom that ensued.

The question that Bibeault pursued was *which failures are due to conditions management could anticipate?* Arguably, in Lehman's case, its business model, not the economy, led it to its failure and Bibeault would call it an internal reason (management failure).

Lehman's CEO, Richard S. Fuld, Jr. admitted to internal mistakes but cited "uncontrollable market forces," rumors and other *factors that were out of his control* as he laid the responsibility on the government for not bailing it out.[209] In other words, Fuld claimed that Lehman's failure was due to external factors that he and his leadership team could not reasonably anticipate.

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[206] Bibeault, page 372
[207] Ferguson, Charles H., "Predator Nation", Crown Business (2012, page 220
[208] Ibid
[209] http://articles.latimes.com/2010/sep/02/business/la-fi-crisis-inquiry-20100902

When Fred Kofman, author of the book *Conscious Business*, talks about having a victim mentality, he uses an analogy to draw a distinction between what is controllable and what is not. He asks his audience to imagine someone who comes in from the rain soaking wet. Then, he asks "why is he wet?" Reliably, the first response is "It was raining." However, Kofman indicates openness to other explanations until he gets "he didn't have an umbrella." He then makes the point that it takes two hands to make a clap sound—you can't make a clapping sound with one hand.

In this story, the "clap" is that the guy is wet. One hand is an external factor that the fellow could not control—the rain. The other hand is an internal factor that he had control of—he could have had an umbrella!

> Quote from *Corporate Turnaround: How Managers Turn Losers into Winners*
>
> "It is never sensible to push any analogy too far, but the collapse of a company is in some ways similar to the sinking of a ship. If a ship is in good condition and the captain is competent, it is almost impossible for it to be sunk by a wave or a succession of waves. Even if there is a storm, the competent captain will have heard the weather forecast and taken whatever measures are needed. Only a freak storm for which quite inadequate notice has been given will sink the ship."
>
> --John Argenti, *Corporate Collapse: The Cause and Symptoms*

Bearing in mind for the "clap" of business failure and an appreciation for the complexity inherent in it, here are the *four external causes* of business failure that Bibeault described:[210]

1. Changes in economic conditions (overall economy, interest rates, credit squeezes)
2. Changes in competitive conditions (new competitors, price competition)
3. Changes in societal conditions (changes in attitudes and/or composition of population).
4. Changes in technological conditions (information technology, automation).

> "Industries facing difficulties are comprised of survivors and failures. Since such companies share exposure to the external factors, the internal factors often provide the best explanation as to why the business failed."
>
> -- Donald Bibeault

[210] Bibeault, pages 27 - 33

Bibeault also identified *two principal internal causes* of business failure—poor management and a weak finance function. Each of them had multiple facets, listed below.

1) Poor management (incompetence, narrow vision, misplaced priorities)[211]
    a) Dictatorship or one-man rule
    b) Lack of management talent and depth
    c) Lack of openness to change
    d) Unbalanced top management team
    e) Ineffective Board of Directors
    f) Pursuit of inappropriate or high-risk strategy
    g) Dishonesty or fraud,

2) Weak finance function
    a) Poor working capital controls
    b) Excessive fixed assets
    c) Excessive debt or "high financial leverage"
    d) Inadequate equity capital
    e) Excessive operating expenses

For each internal cause, Bibeault found that inadequate operating controls contributed significantly to the failure. These are the financial and accounting systems that deal with budgets, product cost, internal reporting, asset valuation, cash flow management and internal controls.

When analyzing failure in this manner—due to external or internal causes— Bibeault concluded that failure due to internal causes was far more common than external causes. He put it this way.

> *My opinion, based on surveys and discussions with over 100 turnaround leaders, is that in seven out of ten cases, decline is internally generated. In another 20 percent of the cases, internal reasons are partially responsible for decline. In broad terms, decline is therefore caused by internal factors about eight out of ten times.*[212]

A famous line from the cartoon strip *Pogo*[213] by Walt Kelly is "*We have met the enemy and he is us*." Pogo, the main character, is an opossum who lives in a swamp near the Gulf of Mexico. He utters that line while looking at the pollution that fouls his bayou, at the dawn of the environmental movement in the early 1970s. It has been evoked in other contexts because, as Wikipedia states, "it perfectly describes [Kelly's] attitude towards the foibles of mankind and the nature of the human condition."

Might Performance Stock mitigate the risk of failure? If employees have incentive to see goals met, wouldn't they be watchful of management and vocal when they feel it is on the wrong track? Bibeault concluded that internal causes explain seventy percent of declines and they are partially responsible in another twenty percent of cases.

The preeminent problem was management. "Internal constraints, such as unions, appear to be of minor importance as a cause of decline. Fraud and bad luck deserve no more than a passing mention." [214]

[211] Page 36 -
[212] Bibeault, page 35
[213] *Pogo* ran as a newspaper cartoon strip from 1948 to 1975; its creator, Walt Kelly died in 1973.
[214] Page 35

When is One-Man (or Woman) Rule a good idea?

One thing that makes the question above provocative is that it is a Rorschach test on one's view on leadership. If one's ideal is a dominating leader who personifies rugged individualism, it seems like a bad idea to allow a large percentage of employees to have Performance Stock that can vote on shareholder matters. If one's ideal is a collaborative leader who views employees as a vital stakeholder, a broad distribution of Performance Stock sounds like a good idea.

There is no shortage of opinion on what constitutes effective management. Chapter thirteen, *Evaluating Valuation*, presents diverse thoughts on the subject. The good news is that the Fairshare Model can accommodate any perspective. Its goal is to provide a better deal for IPO investors, not to impose a style of leadership or corporate governance. A company that narrowly distributes Performance Stock will have different dynamics than one that does it broadly. Similarly, an issuer that adopts a dual class Performance Stock structure will be different than one that has a single class of Performance Stock.

Ideas on how to structure and administer Performance Stock will be developed in the debug phase of the Fairshare Model, which will take place after you, Dear Reader, and tens of thousands like-minded people, signal interest in the Fairshare Model. Whether investors care about how Performance Stock is structured and administered will be tested by early adopters. Meanwhile, consider that the deacons of failure that Bibeault interviewed led him to conclude that "the success or failure of one-man rule depends on the size and organizational complexity of the company, problems of the industry, etc." He wrote:

> ***One-man rule is necessary at the entrepreneurial stage but later causes problems.*** *As Glen Penisten points out: "An entrepreneur has the personality of a creative individual. Very seldom does that personality type bring in disciplined management—a structure which listens to other people, has a board that sets policies. More often that entrepreneur nurtures a submissive management."*
>
> *One-man rule is intended to describe chief executives who make decisions in spite of their colleagues' hostility or reticence; they allow no discussion, will hear no advice. They are autocrats. Not all autocrats are overambitious salesmen, so set upon hyper-successful performance that they cease to believe in the existence of failure. Some are relatively retiring people who impose their will by their superior knowledge.*
>
> *One-man rule is not always bad and is sometimes needed. Thaddeus Taube says that "**One-man rule is a two-edged sword. There's a lot of inbred lethargy in group management.** Very strong one-man leadership can sometimes steer a business in the wrong direction. Yet, it takes very strong leadership in any direction. A company must tread a very fine line between imparting a great deal of authority and strength to a leader while hoping he will be responsive to advice from business associates.*
>
> *It is the rare company that can prosper in the long-run with one-man rule. In extraordinarily complex organizations, it is essential to have management depth and permit managers to participate in decision making. This is necessary for two reasons: first, one man cannot simply handle the complexity of running the organization single-handedly; second, it is essential that the company provide for management succession.* [215]

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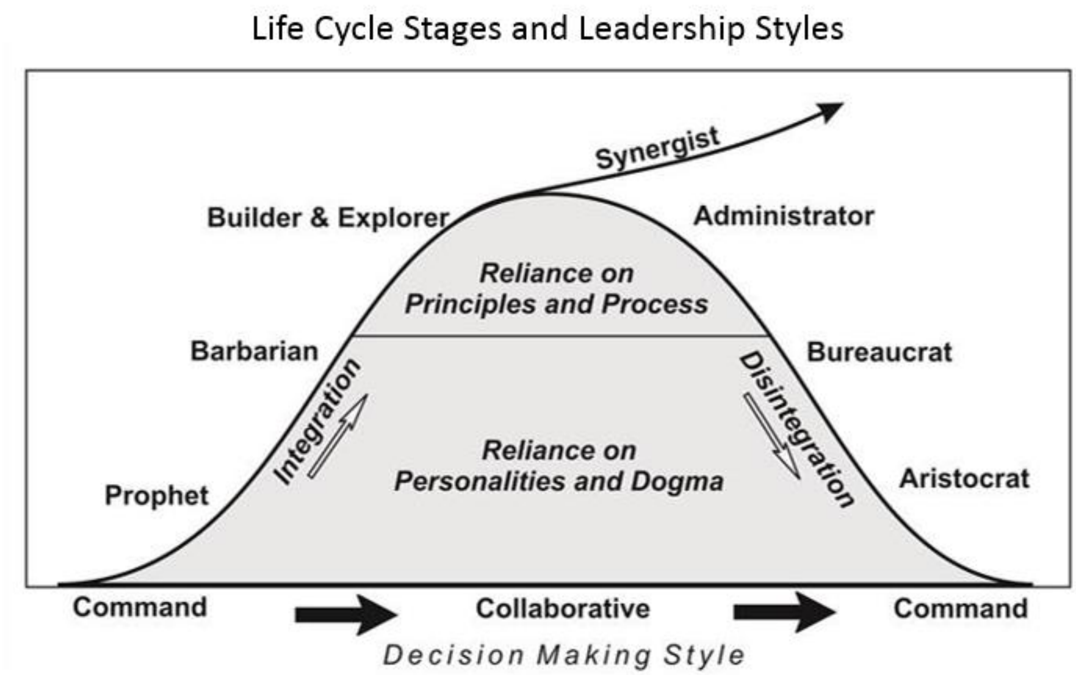
[215] Page 40

Lawrence M. Miller is the author of a number of management books, such as *Barbarians to Bureaucrats: Corporate Life Cycle Strategies* (1990). His blog discusses an August 15, 2015 *New York Times* story that describes a stressfull, demanding culture at Amazon, the online retailer. In it, Miller uses this chart to illustrate how an organization's decision making style evolves over it's life cycle.[216]



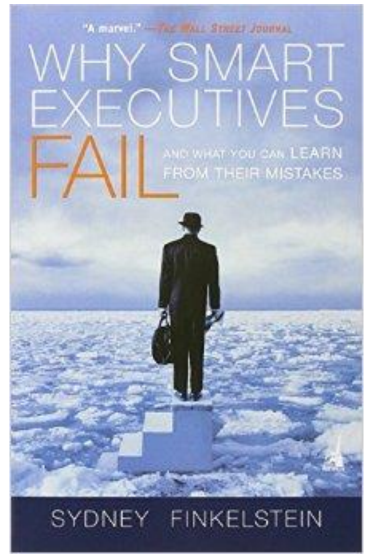
Miller associates a command style with the rise and the decline phase. In the begining, the leader is the prophet with a vision. Growth creates complexity and so a barbarian personality emerges to create processes and integrate them. These stages are defined by the personalities of the leadership and their views on how to conduct business. But as an organization matures, a builder/explorer style emerges that encourages decision-making based on shared principles and established processes. This is conducive to a collaborative culture. The challenge is to continue that spirit and minimze a rule-based administrator mindset, which is associated with declining organizational vitality and can devolve into bureacratic and aristocratic rule, each of which rely on command-based authority.

It is uncontroversial to assert that employees know when management is bad and that they want effective leaders. It's debatable whether many public companies have ways for employees to express their concern about management without jeopardizing their job. A premise of the Fairshare Model is that companies do better when employees have a stake in their company's performance that goes beyond their salary and benefits. So, the model gives them a vote on shareholder matters, which may have a therapeutic effect on a leading cause of failure. But some companies elect to structure their Performance Stock in a manner that supports a command style of decision-making. That is, some may distribute it narrowly or have multiple classes of Performance Stock with different voting rights—more for some (founders, key investors, etc.) and less for others. Might public investors care how Performance Stock is administered? That will be a topic for discussion once interest in the model is established.

[216] http://www.lmmiller.com/2015/08/18/corporate-culture/amazon-versus-the-new-york-times

Seven habits of spectacularly unsuccessful executives

> *Truly colossal blunders don't come in isolation; they seem to come in clusters. Once a company has made a really bad misstep, it often seems as though it can't do anything right. How does this happen? Why, instead of fixing their mistakes, do business leaders regularly make them worse?*[217]



These are questions that Dartmouth College professor Sydney Finkelstein addresses in his 2003 book, *Why Smart Executives Fail: and what you can learn from their mistakes.* His research team sought to "not only to understand why businesses break down, but to focus on the people behind these failures; not only to understand how to avoid these disasters, but to anticipate the early warning signs of failure."[218]

Finkelstein reports *[bold added for emphasis]* that some of the findings surprised his team in that **"many of the qualities that sound like the attributes of a dream enterprise turn out to be the basis for a business nightmare**. For managers, many of the qualities we aspire to emulate, or feel guilty for not having, turn out to be ones we're better off without. **For investors, many of the signposts of success that we strive to identify turn out to be markers for failure."**[219]

The research spanned six years, from 1997 to 2003, and involved study of approximately fifty companies that had suffered a large loss in value as a result of failure. They were largely established American businesses but included some non-U.S. companies and some newly public companies. Data analysis and news reports were supplemented with nearly 200 interviews with executives and managers at the subject companies, competitors, journalists, industry experts, investment bankers and the like. Finding and testing patterns that are reliably and repeatedly present in failure was the focus of the work.

The economy was in the wake of the dotcom and telecom busts as well as feeling the aftereffects of the 9/11 terrorist attacks of 2001 as the book went to press and Finkelstein wrote the following.

> *Over time, it became clear just how deep-rooted and relatively small in number the causes of failure actually were.* ***Businesses that at first appear to have nothing in common turned out to have failed for exactly the same reasons and in much the same way. Even the excuses that we heard from failed managers turned out to be the same in case after case.***
>
> *Despite the vast number of things that could go wrong in something as complex as business enterprises, the really devastating failures turned out to have a surprisingly limited number of causes. Patterns of failure that could be applied not only to the scores of classic, almost common business breakdowns—think Rubbermaid, L.A. Gear, Barneys—but also to the Internet one-year wonders (e.g., Boo.com, eToys, Power Agent, Webvan) and the rogue companies that have dominated the news over the past two years (e.g., Enron, Tyco, WorldCom, Rite-Aid, Adelphia, ImClone Systems).* [220]

[217] Finkelstein, Sydney, page 8
[218] Page 1
[219] Finkelstein, Sydney, page 2
[220] Page 16

Finkelstein points out that his book about failure is ultimately about human behavior—people who "run organizations into the ground." It did not reveal that tactical or organizational matters were a consistent cause, things that might be corrected by internal controls, a different organizational structure or a set of best practices.

> *There's the young entrepreneur who makes it big and then proceeds to destroy everything he's built when he becomes convinced that he has all the right answers. There's the established big-time CEO who invests billions in a venture not because there's a truly compelling case for the venture, but because he wants to. There's the leadership team so in love with their product that they refuse to listen when their customers tell them, and tell them again, that something must change. There's the CEO who pursues acquisition after acquisition unencumbered by such pedestrian concerns as strategic logic and integration. There's the group of executives who persist in self-destructive behavior, despite considerable evidence that such behavior can be toxic.*
>
> *These people don't do these bad things on purpose. They want nothing more than to be successful, and oftentimes some of them were, to a grand degree. They also don't do these bad things by accident. Their actions, and inactions, while not intended to yield the disastrous results that they do, are also not random. It is not so-called "acts of God" that account for the stories of failure in this book, but rather "acts of men and women." And they don't do these bad things because they're not very smart. No, they are very smart, and very talented—often remarkably so—but do bad things nonetheless.*[221]

Finkelstein identifies seven reasons that are popularly cited for business failure—they are listed in the box.

Seven Popularly Cited Reasons for Failure Evaluated in *Why Smart Executives Fail*

1. The executives were stupid.
2. The executives couldn't have known what was coming
3. There was a failure to execute.
4. The executives weren't trying hard enough.
5. The executives lacked leadership ability.
6. The company lacked the necessary resources.
7. The executives were a bunch of crooks.

Each was found to be a weak explanation.

But these reasons don't explain the failures. Furthermore, they are incompatible with leaders who have been successful for years. [222]

The real question was, how did talented executives start getting everything wrong in this sample? We fail to understand failure unless we can identify what caused it and, hence, how to avoid it.

Many of the failures he studied were spectacular; they rendered world-renowned businesses nearly worthless. In the process, they caused thousands of people to lose their jobs and thousands of investors to lose their investments. These failures destroyed hundreds of millions or even billions of dollars of value.

So, Finkelstein asks, if these frequently offered explanations for failure don't reliably explain what happened, what does?

[221] Finkelstein, Sydney, page 14-15
[222] Pages 2 -8

Seemingly inspired by the popularity of Stephen Covey's book, *Seven Habits of Highly Successful People* and fueled with a puckish sense of humor, Finkelstein writes that "to be spectacularly unsuccessful requires some very special personal qualities" in leadership, and he says there are seven of them.

> *It is possible to identify seven habits that characterize spectacularly unsuccessful people. Nearly all the leaders who preside over major business failures exhibit five or six of these habits. Many of them exhibit all seven. Even more remarkable, each of these habits represents a quality that is widely admired in today's business world. As a society, we don't just tolerate the qualities that make leaders spectacularly unsuccessful, we encourage them.*
>
> 1. *They see themselves and their companies as dominating their environments, not simply as responding to developments in those environments.*
> 2. *They identify so completely with the company that there is no clear boundary between their personal interests and their corporation's interests.*
> 3. *They think they have all of the answers, often dazzling people with the speed and decisiveness with which they can deal with challenging issues.*
> 4. *They ruthlessly eliminate anyone who isn't 100 percent behind them.*
> 5. *They are consummate company spokespersons, obsessed with managing and developing the company image.*
> 6. *They underestimate major obstacles, treating them as temporary impediments.*
> 7. *They stubbornly rely on the strategies and tactics that have made them and their companies successful in the past.*[223]

Finkelstein also identifies major warning signs of potential failure. The major ones are unnecessary complexity, out of control spending, a CEO who is personally greedy and not focused on building company value, excessive hype and aggressive, overconfident executive behavior that signals untrustworthiness.

[223] Finkelstein, Stanley; "Why Smart Executives Fail: and what you can learn from their mistakes", Portfolio, pages 213-238

The Start-Up Genome's take on failure

The three failure researchers cited thus far focused on companies that were established. Startups are vulnerable to many of the factors identified but they carry additional risks that larger businesses don't face. What makes startups succeed or fail? That is a question that a group of researchers affiliated with the University of California at Berkeley and Stanford University sought to answer with their *Startup Genome Compass* project in 2011. They examined data from more than 3,200 high growth technology start-ups, mainly Internet related, the type most likely to seek venture capital in a public offering.

Their March 2012 *Startup Genome Report* says "Most founders don't know what they should be focusing on and consequently dilute their focus or run in the wrong direction. They are regularly bombarded with advice that seems contradictory, which is often paralyzing."[224]

The researchers concluded that premature scaling was the chief cause of failure in start-ups. That is, spending money to grow or scale up a business before the product or strategy is attuned with what will succeed in the market. The spending is for headcount, marketing expense, facilities, inventory and so on. Until the product appeals to customers and there is a sound strategy to acquire them, such expenditures are wasteful. If entrepreneurs are soldiers, premature scalers are those who fire off their ammunition before they can clearly see the enemy. As the report put it, "they tend to lose the battle early on by getting ahead of themselves."[225] Other conclusions in the report are:

- Startups need 2-3 times longer to validate their market than most founders expect.
- Startups that haven't raised money over-estimate their market size by 100 times and often misinterpret their market as new.
- Startups that pivot (or change direction) once or twice have better user growth and are less likely to scale prematurely than those that pivot more than twice or not at all.
- Many investors invest 2-3 times more capital than necessary in startups that, in geek speak, "haven't demonstrated that have reached a problem solution fit" yet (i.e., it isn't clear there is a problem for which they have a compelling solution).
- Founders overestimate the value of their intellectual property before "product market fit" (i.e., before demonstrated market value) by 255%

Indirectly, the findings highlight why the defining characteristic of a conventional capital structure—the requirement that a value be set for future performance when new stock is issued—is a big problem for public investors. It is difficult to do reliably well. Now, in a private offering, investors have an opportunity to negotiate valuation. Additionally, the most powerful of them secure price protection. But, IPO investors are presented with the valuation that the issuer gives itself…and many investors are unlikely to know what it is. As asserted in earlier chapters, an IPO valuation is the product of weak market forces where the interests of average investors are "at the back of the bus."

[224] Startup Genome Report; Max Marmer, Bjoern Lasse Herrmann, Ertan Dogrultan and Ron Berman, page 3 Executive Summary, https://s3.amazonaws.com/startupcompass-public/StartupGenomeReport1_Why_Startups_Succeed_v2.pdf
[225] Page 5, Ibid

Closing thoughts on failure

Would it be better for public investors to invest in failure-susceptible companies using a conventional model or the Fairshare Model? There are three overlapping dimensions to this question— employee motivation, corporate governance and valuation. Here are some thoughts to contemplate:

- The Fairshare Model emphasizes reward for what employees can influence—operational results. In a conventional model, stock incentives are typically tied to the stock price, something employees have no control over. Might the Fairshare Model help a company avoid a turnaround situation by focusing incentives on operational factors?

- Might a broad distribution of Performance Stock lower the risk of management failure by intensifying employee interest in their company's performance?

- How might a broad distribution of Performance Stock affect decisions about a course change? On the one hand, employees may object to a radical transformation in the business (e.g., closing or selling a line of business). On the other hand, it is uncommon for a CEO to come up with a successful turnaround plan that lacks employee support.

- Would Apple's Steve Jobs, a dominating leader with obsessive qualities, have been attracted to the Fairshare Model? If not, is that bad? After all, Captain Ahab in Herman Melville's *Moby Dick* was dominating and obsessive too.

As you consider these questions, also consider what Ed Whitacre has to say about employee involvement. He was CEO of two iconic American corporations AT&T and General Motors, as they underwent turnarounds and he wrote the following in his 2013 book, *American Turnaround Reinventing AT&T and GM and the Way We Do Business in the USA*.

> *99.9% of the people out there want the exact same thing: to feel good about their lives, to feel that they're not failures, to feel like they're contributing and are part of something that is having a positive impact on their kids and families.*
>
> *That inner need to contribute and be a part of something good and positive is a powerful force. People want to be engaged and be listened to and taken seriously, they want to know that they matter.*
>
> *Employees are on the front lines every day, so they know, pretty much, how things are going. And if things aren't going so good, they can often tell you, with a high degree of accuracy, why that is.*
>
> *But they have to be engaged.*

Add to this mix an appreciation for the unique qualities of entrepreneurs who often devote themselves to trying to make their enterprise succeed in the face of daunting odds, giving far more of themselves than other employees. That the leadership qualities a business needs to succeed can change during certain phases.

These and other questions will be widely discussed in the next phase of the development of the Fairshare Model. Once there is investor interest in the model, experts in securities, organizational development and other areas will have incentive to debug and fine tune it.

The Fairshare Model envisions a broad distribution of voting Performance Stock among employees but it need not be that way. An issuer might distribute it narrowly, or, it may have multiple classes of Performance Stock with different voting rights—more for some (founders, key investors, etc.) and less for others.

The defining characteristic of the Fairshare Model is not corporate governance; it is IPO valuation. But new thinking about corporate governance and employee motivation is a byproduct of its radically different approach to valuation in the public capital market. Chapter five describes types of companies that may adopt the Fairshare Model—undoubtedly, there will be variation in how they implement it.

With respect to valuation, this book is replete with reasons why investors should be skeptical about the valuation venture-stage issuers give themselves. This chapter reports that one scholar of failure finds that loss of market and management failure was the cause of more than half of failures. Another concludes that internally generated causes play a dominant role in failure. Yet another identifies dysfunctional qualities in senior leadership that might seem to presage success but actually heighten the risk of failure. And the Startup Genome report finds that company founders are often unsure what their priorities should be, that the successful ones tend to have to pivot aspects of their strategy and vastly overestimate the value of their intellectual property.

We also learned that founders are vulnerable to significantly misjudging where they are, what they need to do and, by extension, the value proposition that they offer investors.

An earlier chapter observed that ideas are worth nothing unless executed; execution is worth millions.

“Unicorn” startup Good Technology raised $388 billion over 13 private funding rounds. It was valued at $1 billion in April 2013; in September 2015, it agreed to be acquired for $425 billion, less than half its top valuation.

---Source: Marketwatch.com

Onward

The next chapter considers other objections people have to making it easier for public investors to invest in young companies.

Chapter 18: Other Objections to Public Venture Capital

Preview

- Foreword
- Fraud vs. Unethical
- Myths about venture capitalists
- How scalable are VC funds?
- How scalable is angel investor capital?
- How the Fairshare Model complements Angel investing
- Venture stage investing is inappropriate for average investors because….
- We are but animals
- Companies should not want small investors to provide capital because…
- Onward

Foreword

Fraud, overvaluation and failure are the principal concerns for those opposed to seeing average investors involved in venture capital (that isn't made available by Wall Street investment banks). But there are other, sometimes vaguely sensed, objections that can be boiled down to "let's leave venture capital investing to the VCs and angel investors." This chapter touches on matters relevant to that sensibility.

Fraud vs. Unethical

I have a confession to make, Dear Reader. I have trouble reconciling my twin advocacy for average investors and liberalization of securities law with my concern that unethical sales practices will send vulnerable investors to the demon of loss.

It is as if I am Pandora, but I'm not driven by curiosity to open a box of unknowns. Instead, I know there is something good in the box, a lower cost of capital, and I want to release it. The problem is, I know there is something bad in the box too, unethical behavior. My dilemma is that I can't figure out how to release the good and contain the bad; unethical behavior is likely to accompany the liberalization of securities laws because some people are susceptible to it.

The fear of being caught doing something illegal inhibits unethical behavior. But there can be a difference between what is legal and what is right, and that is the worrisome territory.

To illustrate, I'll tell you about my dear mother. She lives on a fixed income, social security. She is a heavy consumer of cable TV and gets loads of junk mail, so she's exposed to many appeals for money and pitches for marginal products. She also fancies herself a better investor than her track record suggests. All this and the frailties of age makes her vulnerable to unethical companies and sales people. People like my mother come to mind as I think about venture-stage companies selling stock to the public.

A few years ago, she bought gold coins from a dealer located in another state. After seeing a stream of advertisements and pundits exhort the virtues of an investment in gold, she phoned in an order without any due diligence. She paid $11,000 for coins that were worth no more than $3,500 at the time. It was an awful, uninformed and emotion-driven decision. After I complained to the seller, he offered to buy them back for $2,800. My mother refused, maintaining that they would go up in price.

Was the seller unethical? Certainly. He knew his price was excessive and could not mistake my mother's lack of sophistication. Was she a victim of a fraud? Yes, in the sense that she did not get what she expected—a competitive price. But it is not prosecutable because she initiated the call, required nothing more than the folksy assurance that it was a wise choice and the coins are (apparently) gold. The seller did what was required to fulfil a legal contract. Still, the operation reminds me of a "boiler room" where questionable investments are hawked.

Such behavior might be punished if gold coins were a security. My mother's state securities regulator could use the broad, anti-fraud provisions of its blue sky laws against the seller. And if the seller was a securities broker-dealer, the industry's self-regulatory organization, FINRA, might take action. SROs exist in industries that are subject to government regulation such as real estate and medicine. They are trade associations with quasi-governmental authority; they create and enforce rules for their members and they protect their interests much like a trade guild. FINRA has higher conduct standards for its members than government. For instance, it requires a member to evaluate the suitability of an investment for an investor where the SEC and state agencies do not. So, were gold coins a security and the seller a broker-dealer, FINRA might require it to rescind the sale or refund a (greater) portion of it.

This suggests that unethical sales practices involving equity crowdfunding can be better policed if sellers must be a broker-dealer. But what about direct public offerings? Requiring issuers to use a broker-dealer to sell their stock is akin to requiring home owners to hire a realtor to sell their property.

Aside from that, I'm skeptical that FINRA is the right organization to oversee a new breed of online platforms as its rules fit the highly profitable broker-dealer industry and may be ill-suited to the needs of an embryonic form of business that may have low margins and present a competitive threat to FINRA members. They may use their influence to ensure that rules are created or enforced in a manner that handicap online platforms.

Often, organizations act to protect their members from competitive pressures. Undoubtedly, Dear Reader, you can think of examples but I'll share one with you.

Today, it is unremarkable to find free and reliable data on real estate listings via the Internet. In part, that is the result of the 2008 settlement agreement between the U.S. Justice Department and the National Association of Realtors (NAR), the SRO for real estate broker-dealers. It settled an antitrust lawsuit brought by the government that challenged NAR rules for its Multi Listing Service (MLS) that inhibited competition. NAR agreed to "replace them rules that discriminate against innovative brokers who use the Internet to provide high-quality, low-priced brokerage services to consumers."[226]

A back story is that in 1991, I worked with a start-up that was innovating in the real-estate space. This company marketed video discs—a now-obsolete technology—that had street-shot pictures of houses with information routinely found in MLS listings. Their effort in what would became online real estate was hindered by NAR's restrictions on MLS data that protected the interests of its members. My client's prospects would have been brighter if these anticompetitive rules, which took nearly a quarter of a century to be overturned by government, did not exist to begin with.

So, my skepticism about FINRA is based on human nature. I suspect that powerful members in the SRO are hostile to innovative online platforms that can reduce the cost of capital because that might translate into a smaller paycheck for them. Accordingly, I suspect that FINRA will raise, maintain or enforce rules in ways that inhibit such competition.

It is a classic problem. The ancient Roman poet Juvenal phrased it in Latin as "*Quis custodiet ipsos custodes?"* which translates as "Who will guard the guards themselves?"

That said, consider that in securities, the product itself—a conventional capital structure—may encourage sellers to engage in unethical practices. After all, a value must be set for uncertain future performance at the time of an offering and "possibility thinking" is the fairy dust that dazzles the vulnerable. There is no need to value future performance in the Fairshare Model, so unethical sales practices could be less of a problem—time will tell.

As you ponder the challenge of unethical selling practices for securities, here are some questions to think about.

- What information might help investors better protect themselves? I make a case for valuation disclosure in chapter fourteen, but what else might help?
- Is there a role for investor certification? Instead of relying on income and wealth to establish investor suitability, might regulators define a class of investor based on knowledge and sophistication and set purchase restrictions on investors who fail to meet the standard?

Another response to the challenge of protecting the vulnerable investors is to ask, is innovation in venture capital even necessary? Shouldn't we rely on the professionals in the VC industry to meet the needs for young companies? Bearing in mind that for decades, such investors have been able to invest in

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[226] http://www.justice.gov/atr/case/us-v-national-association-realtors

Myths about venture capitalists

"Six Myths about Venture Capitalists" appeared in the May 2013 issue of the *Harvard Business Review*. In it, Diane Mulcahy, director of private equity at the Kauffman Foundation and a former VC herself summarizes a report that she co-authored, *We Have Met The Enemy And He Is Us: Lessons from Twenty Years of the Kaufman Foundation's Investments in Venture Capital Funds and The Triumph of Hope over Experience*[227] The report is written from the perspective of a limited partner, an investor, in VC funds.

"The myths surrounding venture capital can be powerful," Mulcahy writes. In order to provide a realistic sense of the industry and what it offers, she challenges some of the most common ones:[228]

Myth 1: Venture Capital is the Primary Source of Startup Funding

"VC financing is the exception for startups. Historically, less than 1 percent of U.S. companies have raised capital from VCs, and the VC industry is contracting. But less venture capital does not mean less startup capital since non-VC sources, such as angel capital, are growing."

Myth 2: VCs Take a Big Risk When They Invest in Your Company

"VCs take risks with investors' money, not their own. The typical VC commits only 1 percent of partner capital to a fund while investors commit the remaining 99 percent. The VC revenue model that generates guaranteed and cumulative management fees regardless of investment performance insulates VC partner personal compensation from the risk of poor returns."

Myth 3: Most VCs Offer Valuable Advice and Mentoring

"VCs differ in how much effort they put into these nonmonetary resources, and the quality of advice and mentoring from VCs can vary widely, so founders who want more than capital from their investors should conduct due diligence on a VC firm they are considering."

Myth 4: VCs Generate Spectacular Returns

"The VC industry underperforms on the returns it generates for its investors."

Myth 5: In VC, Bigger is Better

"The contrary is true for both the industry and individual funds. Industry and academic studies show that VC fund performance declines as fund size increases above $250 million. "

Myth 6: VCs are Innovators

"VCs may be well known for funding innovation, but the VC industry and business model have not seen significant innovation in two decades. The VC fund structure, fund life and economic terms have remained the same for more than 20 years." Mulcahy has a note for the VC industry: "Increasing the standard 2 and 20 compensation model to 2.5 and 25 is not innovation." [The first figure is the annual percentage fees on committed capital. The second figure is the percentage of the profit on an investment that a VC retains (a/k/a the carry).]

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[227] "We Have Met the Enemy..And He Is Us" , by Diane Mulcahy, Bill Weeks and Harold S. Bradley, May 2012 http://www.kauffman.org/what-we-do/research/2012/05/we-have-met-the-enemy-and-he-is-us

[228] Six Myths About Venture Capitalists, by Diane Mulcany, Harvard Business Review, May 2013, https://hbr.org/2013/05/six-myths-about-venture-capitalists

How scalable are VC funds?

Many people who oppose greater access by public investors to venture capital investing want to see more venture capital available for young companies. Some favor more government involvement but, in the U.S. at least, there is little prospect for that. Most expect the money to come from VC funds, the source the Kauffman report de-mythologizes.

A fundamental question for policy makers emerges—is reliance on VCs a healthy and sustainable strategy? Put another way, are VC funds scalable? Here are some reasons to believe they are not.

- VCs tend to invest in companies located no more than 1.5 hours from their office. Since most cluster in certain areas, VCs may not expand the geographic supply of capital.
- VCs congregate around sectors that are "hot"; they all want to take the same dates to the dance and may not provide capital to companies outside of the most popular categories.
- VCs frequently invest in male entrepreneurs who went to certain universities. The pool of talent is more diverse than that slice of humanity.
- An increase in the number of VCs may not achieve the goals of this option. Individual VCs vary significantly in their skills, wisdom and operational backgrounds; it takes years for one to be seasoned by a range of situations and different economic cycles. It also takes time for a new partner to be accepted by his/her partners.
- At a personal level, individual VCs may be too taxed to significantly expand the number of deals that they oversee. They have demanding jobs; there is fund-raising, networking, deal screening, due diligence, and monitoring portfolio companies, some of whom require their intense attention. Individually, they naturally aspire to get the best work-life balance they can. Therefore, as funds grow in size, they are more likely to pursue deals where more can be invested versus an increase in the number of deals.
- VC firms risk becoming institutional as they scale. This is a high-touch, high-risk business—you can't just grow its size and expect the quality of outcomes to remain stable. Think big banks…big anything.
- Innovative opportunities may be shunned in favor of safer deals.
- VC money is "on the meter"---this can pressure companies to scale prematurely.
- Limited partners, like the Kauffman Foundation, who provide 99 percent of the capital in a VC fund, are disgruntled with the compensation model for VC general partners.

The biggest reason to oppose preservation of venture capital as a province for VCs is that it perpetuates the idea that average investors *should be* the Next Guy, relegated to paying high valuations for risky ventures. This is unfair and it continues an unfortunate tradition of weak market forces in the capital markets, as described in chapter four, *The Problem with a Conventional Capital Structure*, and chapter ten, *The Tao of the Fairshare Model*.

How scalable is angel investor capital?

The amount of capital invested by angel investors has been growing rapidly and this source is highly scalable. In the U.S., the SEC estimates that 12 million households meet the income and net worth criteria to qualify as accredited investors.[229] percen

The Center for Venture Research at the University of New Hampshire estimates that in 2014, there were 316,600 active accredited investors in the U.S. who invested $24 billion in entrepreneurial ventures. By these measures, only 3 percent of those who qualify to be accredited investors engage in angel investing. So, it is easy to see the potential for angel capital to be much higher than $24 billion!

The top of the following table has data on U.S. VC firms compiled by the National Venture Capital Association for 1994, 2004 and 2014. The bottom has data on U.S. angel investors from The Center for Venture Research for 2004 and 2014; it has no data for 1994 as activity was embryonic.

	1994	2004	2014
Venture Capital Firms [230]			
No. of VC firms	385	985	803
No. of VC funds (i.e., a firm may have more than one fund)	635	1,803	1,206
No. of professionals in VC firms	3,735	8,964	5,680
Angel Investors[231]			
No. of active angel investors	n/a	225,000	316,600
No. of women angels	n/a	11,250	82,600
No. minority angels	n/a	8,100	25,300

There are many, many more angel investors than VCs. And they are inclined to collaborate; more so than VCs who, after all, can be competitors or have competing interests. In contrast, angels share insight on how to invest, to screen deals and perform due diligence on them. In many ways, they operate with a hive mentality. And as a result of the JOBS Act, they conduct activities on a growing number of online platforms—bigger, better connected hives. The capabilities of angel groups is likely to grow in power in the years ahead. This, and the potential for the number of angels to increase suggests that it is scalable.

The number of angel investors will surely reach half a million before there are 10,000 professionals in VC firms.

Angel investors are more diverse than VCs. Note how the number of women and minority investors climbed from 2004 to 2014. During that time, the number of VCs shrank, making them more vulnerable to criticism that their industry is dominated by white males who share a common pedigree.

Now, of course, VCs can apply far greater firepower to an opportunity than angel investors. They can fulfill a company's need for capital faster and with fewer complications than angels, especially as the amount to be raised grows. VCs write checks for millions of dollars. Individual angels use their own money

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229 "Accredited Investor Pool" presentation made Dec. 17, 2014, by Rachita Gullapalli; SEC Division of Economic and Risk Analysis; http://www.crowdfundinsider.com/2014/12/60121-number-accredited-investors-deck/

230 2015 Yearbook, National Venture Capital Association, pg. 9, http://nvca.org/research/stats-studies/

231 Jeffrey Sohl, "The Angel Investor Market in 2014" and "The Angel Investor Market in 2004", Center for Venture Research, https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/webform/2014%20Analysis%20Report.pdf and https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/2004_Angel_Market_Analysis_Report.pdf

and write smaller checks—amounts from $20,000 to $50,000 are common. So, it takes longer to close an angel round of financing.

Still, intriguingly, as the table below shows, the aggregate amount of angel investing in 2004 and 2014 ($22.5 billion and $24 billion, respectively) approximates the amount of new VC capital raised in those years ($17.6 billion and $29.9 billion, respectively).

Amounts in $ billions except for the avg. angel investment	**1994**	**2004**	**2014**
Venture Capital Firms			
VC capital raised this year	7.6	17.6	29.9
VC capital under management (includes amounts raised earlier)	33.2	271.1	156.5
Angel Investors			
Angel capital invested this year [232]	n/a	22.5	24
Avg. annual investments per angel in thousands[233]	n/a	100	75.8

The prior table shows that the number of angel investors increased from 2004 to 2014, from 225,000 to 316,000, nearly 41 percent. The table above shows that the amount invested by angels increased from $22.5 to $24 billion, just 6.6%. That indicates that the average annual investment per angel fell from $100,000 to $75,800.

Considering that such a low percent of accredited households participate in angel investing, this source of capital has greater potential to scale than VC firms. One can imagine it growing to $50 billion by 2019 because as a result of the JOBS Act, the SEC allows online platforms to facilitate angel investments without being a broker-dealer. Private offerings have never been so easy for accredited investors to find, compare and perform due diligence on, therefore, the number who invest in them is likely to climb.

Angel investors have a relevant range for deal size. They are able to fund early rounds of capital—$2 million scratches the limit and it can be lower in many geographies. Wherever the ceiling is set, there is an amount of money that becomes increasingly tough for a company to raise from angels. That amount may increase as a result of online platforms.

VCs are well positioned to fund large, expansion rounds. But as pointed out in chapter ten, The Tao of the Fairshare Model, VC's secure terms that enable them to effectively pick the pockets of angel investors with respect to return on investment and even take their pants. So, there is a risk to angels when a company they have invested in takes VC money. The company may succeed but they may benefit far less than a VC or not at all, even though they invested before the VC.

A question emerges. Might the angel investor eco-system benefit if an IPO becomes a viable alternative for companies to raise rounds of venture capital?

[232] Jeffrey Sohl, "The Angel Investor Market in 2004", Center for Venture Research, https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/2004_Angel_Market_Analysis_Report.pdf

[233] The number of active angel investors increased nearly 41% from 2004 to 2014, from 225,000 to 316,000. Yet the amount invested increased just 6.6%, from $22.5 to $24 billion. What gives? The average annual investment fell from $100,000 to $$75,800. Possibly, due to the effect of the Great Recession and/or an increase in caution.

How the Fairshare Model complements Angel investing

"Yes!" Angel investors would absolutely benefit if public offerings were a more viable option for capital that VCs provide. An IPO option might have more appeal than a VC or help the company negotiate a better VC deal. Those who don't have VC interest may have an alternative path to pursue. Either way, more options for companies is a good thing for their angel investors.

To be sure, VCs are and will remain the principal source of expansion funds to companies because they offer many advantages. But, this source is not as scalable as angel capital and can ultimately be unfriendly to angel investors. Plus, VCs do not support the range of opportunities that angels do. Therefore, public investors can complement angel interests in ways that VCs do not.

That said, which might be better for angel investors when a company has an IPO, a conventional capital structure or the Fairshare Model? Generally, they will prefer a conventional model because it is, well, traditional. Beyond that, it depends on whether the angels intend to sell or hold their shares.

If they plan to sell, angels will favor a conventional deal because the IPO valuation will reflect expected future performance. Those plan to hold will view the IPO as another venture round and favor the Fairshare Model as has little downside valuation risk, offers a liquidity option and Performance Stock, which can super-charge the company's prospects and thus, the profitability of a long term perspective.

Intriguingly, a Fairshare Model IPO can be a hybrid of a private VC round and a conventional IPO.

- If priced like a VC round at the IPO, Investor Stock may climb in secondary trading to a level that anticipates future performance.
- Angel investors who sell some shares in the secondary market reduce their at-risk capital.
- Angels with a position in the issuer's Performance Stock have additional long-term upside.
- Unlike VCs, public investors are not be positioned to "pick the pocket" of angel investors.

There is another angle of possible interest to angel groups—they can build a reputation for quality deal flow with IPO investors. Their involvement with a company can suggest a level of quality to public investors akin to the *Good Housekeeping* magazine seal of approval.[234] This can happen when such companies use a conventional capital structure, but at greater reputational risk. If expectations are not met, IPO investors are less likely to realize a return and, should this happen often enough, they will not view the angel's involvement as a reliable indicator of quality.

In contrast, angels that affiliate with the Fairshare Model can foster a favorable impression with public investors who view the IPO as having higher odds for success due to angel involvement and low risk of overpayment due to the Fairshare Model.

[234] Consumer Reports magazine and online sites like Yelp offer similar

Venture stage investing is inappropriate for average investors because….

Let's shift perspective slightly. Some oppose the JOBS Act because of the demon of investor loss, concern about unethical sales practices or because they think VCs and angel investors should be the source of venture capital. They implacably oppose making it easier for companies to sell stock to average investors because it is just too difficult for them to make money with these types of investments. This feeling can be expressed in a sentence that begins:

"Venture stage investing is inappropriate for unaccredited investors because…."

The table below lists arguments that could complete the sentence as well as alternative solutions to make investors less vulnerable to loss.

Venture stage investing is inappropriate for unaccredited investors because….	
Argument	**Alternative solution to banning such investments**
…average investors cannot absorb the losses associated with venture stage investing	Deter investors from investing more than a modest amount in small, high-risk ventures in a given year. [This is called for in the equity crowdfunding part of the JOBS Act (Title III).]
…average investors are not positioned to perform due diligence.	Allow average investors to join groups that pool due diligence on new public offerings and provide other non-commission based services. Accredited investors are allowed to do this via websites and group meetings without being a broker-dealer. And investment clubs comprised of average investors have been allowed to pool due diligence stocks that are already publically traded. But as discussed in chapter six, some regulators oppose allowing non broker-dealers to offer average investors such services for public offerings, which preserves the broker-dealer franchise.
…average investors are not knowledgeable enough to assess the risk.	Securities regulators could require issuers to disclose the valuation they give themselves (discussed in chapter fourteen). This would encourage investors to be more valuation savvy and so, reduce the likelihood that they lose money because they overpay. It would also encourage issuers to compete for investors by offering better terms.
…average investors are not knowledgeable enough to assess whether a start-up has reasonable prospect for success.	Promote investor educator on the ways that an investment in a company can result in a loss. If done in conjunction with the solutions above, average investors will be able to protect themselves. .
…scams abound where small companies and small investors connect.	Enforcement of law when fraud is suspected.

Collectively, these solutions foster a balance investor protection and opportunity with better access to capital by entrepreneurial companies.

We are but animals

As just suggested, compared to accredited investors, average investors are disadvantaged with respect to performing due diligence and their ability to assess risk and a new venture's prospects for success. An unkind way to express that concern is to say that they are not smart or savvy enough to be reasonably successful at this type of investing.

Put aside for a moment the fact it is a hard area for anyone to succeed at, as well as the notion that there are other benefits that accrue from investing in early-stage companies (i.e., it is fun, leads one to engage the world in good ways and it contributes to an entrepreneurial culture). Let's focus on the whether a group of average investors might be up to the task—the kind that is easy to form on the Internet. To begin, let's concede that many individuals will know far, far less than an individual VC.

Next, consider whether collectively, using the dynamics of modern networks, they might acquire capabilities that increase the odds of making a well-considered decision to invest or not. There are several online communities devoted to increasing investor savvy about traded stocks (i.e., The Motely Fool, Seeking Alpha). It is inevitable that similar websites will enhance the ability of individual investors to assess small company IPOs. After all, it's nature!

PBS's *Nova Science Now* has an episode called *What Animals Are Thinking* that examines collective intelligence in animals like bees, fish and even slime mold. [235] Those who fear the worst for average investors may take heart from research that shows that slime mold, which has no brain or nerve system at the individual cell level, can, as a collective, find food on the other side of a maze. It does this by communicating along the colony's collective body—comprised of thousands of individual slime cells. By working together, they can do some smart things. In the program, researcher Iain Couzin notes that, "It completely blows away this idea that you have to be smart to solve problems. We used to think of intelligence as having one large brain, whereas now we realize you can build intelligence in other ways."

> *For example, slime molds can find the shortest route through a maze towards a piece of food. First, the slime mold extends its tendrils through every corridor, essentially mapping the entire maze. It then retracts every tendril that didn't find food, leaving behind a trail of slime that acts as a kind of external memory. The trail reminds the slime mold that certain corridors are dead ends. It avoids these areas and grows exclusively along the shortest path from the beginning of the maze to the tasty treat.*
>
> *But that's not all. After scientists placed food in the relative position of major cities and urban areas, slime molds accurately recreated the rail system of Tokyo, and the major roadways of England, Canada, Spain, and Portugal. In other words, this one cell solved a real world problem that it took teams of engineers to figure out.*[236]

To be clear, this tongue in cheek reference is to suggest that average investors may develop surprisingly effective ways to protect their collective interests.

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[235] Stream it here http://www.pbs.org/wgbh/nova/nature/what-animals-thinking.html

[236] www.pbs.org/wgbh/nova/nature/slime-mold-smarts.html

Companies should not want small investors to provide capital because…

One final shift in perspective. Some opponents of small investors in early-stage companies base their arguments on the interests of companies, not investors. They say, it is better to raise venture money from a VC because there is less fuss and you get the "VC value-add." There are good arguments for this, three of which are below, along with rebuttals.

1. Such companies need oversight from investors who can ensure management is held accountable or make changes in management, when necessary. Small investors are not positioned to do this.

   Rebuttal

   - To be in such a situation is a one of the most painful scenarios that a company can go through and it can devolve to civil war between entrepreneurs and their investors.
   - For entrepreneurs, it brings out the "dark side" of the VC value add—the bright side being money, advice, network, etc. And the impetus for conflict my not be performance related.
   - For angel investors, this oversight can cut both ways. If changes are called for, it can be helpful to have a VC manage it. On the other hand, when things are not going well, a VC may squeeze angel ownership.
   - Ideas on how to deal with management discipline/change will be explored in the second phase of the Fairshare Model's development, after interest in the model is apparent.

2. Early stage companies benefit from investors who can facilitate alliances with other businesses. Small investors lack such a network, so, a company that relies on them for capital is less likely to be successful, even if its product is good. They simply can't run fast enough to succeed.

   Rebuttal

   - A company can attract influential investors at or after the IPO. Plus, for some businesses, having many small investors might help it market its product.

3. Average investors are unlikely to provide the future capital needed and large investors who can provide it will shy away from a company with small investors.

   Rebuttal

   - An issuer that adopts the Fairshare Model could raise additional capital via a secondary offering or a private offering (i.e., Private Investment in Public Equity or PIPE).
   - If stock warrants are attached to IPO shares, the issuer can be positioned to raise more capital. For example, one can structure a $5 million IPO with a series of warrants that can result in $20 million in additional capital being raised at higher valuations over time.

Point is, there are ways to address such concerns. But, with those who believe that public investors should be the ultimate Next Guy, with respect to valuation, there is no common ground.

Onward

This concludes this section. Section V will discuss the Fairshare Model from the perspective of game theory, behavioral finance and secondary market investors.