

Standards Of Professional Conduct In Venture Capital

By Nirit Eshkar Tolkowsky and Gideon Tolkowsky



The venture capital industry is currently at a crossroad. The global high-tech crisis, together with the general economic recession, have put this industry in a state of consolidation and soul searching. The venture capital community should take advantage of this pause in order to learn its lessons from the past and upgrade its professional skills, with an eye toward future recovery.

One of the important areas to be looked at during this period of low tide is that of adequate standards of professional conduct. During the bubble days, much criticism was directed at the venture community, mainly by entrepreneurs, on the ground of its professional conduct. One can argue that some of this criticism is an unavoidable part of the overall relationship between venture funds and entrepreneurs at large. But such argument does not exempt the venture community from sober self-examination.

The upgrading of professional venture capital standards may serve not only the entrepreneurs who interact with venture funds but, even more so, the funds' own interests. These interests have to do with the venture community's relationships with its own investors, with entrepreneurs, and among the funds themselves. An examination of the professional standards guiding these relationships may become a cornerstone in the upgrading of the overall quality of the venture trade. Among other effects, it will help re-build the confidence of institutional investors in venture funds, in the wake of a period of heavy financial losses and general loss of faith in private equity.

A discourse that would evolve within the venture community around standards of professional conduct would elevate the overall awareness of this issue. For illustration, let one briefly refer to specific examples. These are taken from the three main crossroads standing at the heart of the venture trade: The relationships between funds and entrepreneurs, among funds, and between funds and their investors.

Adequate professional conduct between funds and entrepreneurs includes, for instance, the issue of timing of the extension of an investment proposal to an entrepreneur. Should the proposal be extended only after the completion of most of the due diligence work, at which stage the offer is reasonably firm? Or, should it be extended earlier in the process, in order to bind the entrepreneur to the fund making the offer? The latter practice may, in some cases, be perceived as a reflection of lack of good faith.

The next example refers to the work relationships among funds. Specifically, it has to do with a scenario where several funds simultaneously converse with the same entrepreneur. One can ask at what stage this parallel process ceases to represent fair competition in a free market and assumes the characteristics of cartelism. When several funds looking at the same deal compare notes among

them – does this represent an intention to syndicate the deal, in good faith? Or, is it an attempt to form an ad-hoc cartel? Furthermore, when the funds communicate among themselves and, at the same time, separately negotiate with the entrepreneur, this practice can undermine the sense of trust among fund managers. It follows that a late shift to collaboration among funds in regard to a specific prospective investment may pose just as much threat to the standards of conduct as early collaboration does. While the latter may be interpreted as cartelism, the former can undermine inter-funds trust. One needs to find the proper point of balance between these opposing tendencies, for the sake of the long-term well being of the venture community in its entirety.

The third example refers to the relationships between funds and their own investors. Often, a fund manager who sits on the board of a portfolio company is allocated stock options of this company, be it in an early stage of the company's life or at a public offering. When should the fund manager be allowed to take these options to himself? Alternatively, when should he or she hand them over to the fund they represent?

None of these three examples has an obvious answer. They all need to be addressed via an intra-community discourse.

Notably, the issue of adequate professional conduct is addressed by the National Venture Capital Association in the United States. This Association's mission statement includes the following statement: 'Members will conduct their business in a professional way and will not engage in practices that would be damaging to the image of the venture capital industry'. Broadly speaking, this type of an issue should not be left solely to the applicable venture capital association. It requires the development of a community-wide, active and lively discourse. This can be achieved via intra-community discussion groups, as well as through conferences, the media and the like.

A discourse around professional standards of conduct will be of particular value to the venture capital trade once it is launched into a new up-cycle. Now is the time for it to start gaining momentum. Parenthetically, let one note that an active discourse of adequate professional conduct may also serve the venture community well in cases of lawsuits brought against its members. The discourse will provide a slate of reference in legal discussions. Clearly, though, the main purpose would be to convey the right messages to entrepreneurs, to fund investors and to the fund managers themselves.

A professional community that constantly examines its own norms and practices will win the respect and confidence of the environment within which it functions.

For more information, or for contact details, visit our website, www.bmecapital.com