

**CGS Center:** There are a lot of research and studies on the corporate governance structure of publicly held firms, however, venture capital finance and private equity financing are also increasing at a fast rate. What kind of criteria venture capitalists use to overcome the information asymmetries between the portfolio firms and entrepreneurs? How do they benefit from/utilize good governance criteria when evaluating the investment opportunity?

**McCahery & Vermeulen:** Venture capitalists are specialized intermediaries that direct capital to firms and professional services to companies that might otherwise be excluded from the corporate debt market and other sources of private finance. Venture capital financing is used to invest mainly in small- and medium-size firms with good growth and exit potential. Typically, venture capital firms concentrate in industries with a great deal of uncertainty, where information gaps among entrepreneurs and venture capitalist are commonplace. These ventures are identified as financially constrained. Start-up firms rely on venture capital as one of their main sources of funding. In contrast to the corporate governance structure of the publicly held firms, where dispersed shareholders have disproportionately less control than equity, the governance arrangements of venture capital backed firms tends to allocate greater control to investors.

### **Screening**

Some of the success of the portfolio company's returns will be influenced by the effort and skill expended in screening 'good' from 'bad' entrepreneurs. The basic approach to the screening of venture capital investments involves a direct and indirect component. First, direct screening serves to overcome the information problem in two important respects. Direct screening involves selecting the 'good' projects based on the examination of the prospective pool of entrepreneurs' business plans. Because venture capitalists specialize in specific technologies and markets, and evaluate many potentially good investment opportunities, the information asymmetries between portfolio firms and entrepreneurs are reduced. In an recent empirical study of forty-two ventures by ten venture capital firms, portfolio companies tend to use four groups of criteria when evaluating an investment opportunity: (1) attractiveness of the project analyzed in terms of market size and growth, product attractiveness, the strategy, the likelihood of customer adoption, and the competitive position of the venture; (2) the quality of the management team and its performance to date; (3) deal terms; and (4) the financial or exit condition. Based on these analyses, the venture capitalist can make reasonable projections about the project's risks and the likelihood of success.

### **Deal Terms**

The most suitable type of security to use in early stage ventures is convertible preferred stock. Convertible preferred equity is considered optimal because it secures downside protection for venture capitalists by providing seniority over straight equity, while it supplies entrepreneurs with sufficient incentives to take risks in order to create higher final firm value.

For instance, convertible preferred stock gives the venture capitalist a fixed claim on the returns of the venture in the form of a dividend. The unpaid dividends accrue and must be paid to the convertible preferred equity holders before the dividend is paid out to common stock holders. Common shares provide incentives to the entrepreneur as compensation is thus based on the performance of the venture. Using convertible preferred stock also gives venture capitalists a senior claim on cash flow and distributions in the case where the venture is liquidated.

### **Exit**

The exiting of the portfolio company investment is the final stage in the venture capital process. Venture capital firms have several options when considering exiting a venture. There are six ways in which a venture capital firm can exit a venture, namely: (1) the sale of a company's shares through an initial public offering; (2) the sale of shares to another company or a trade sale; (3) the repurchase of the shares by the company by leveraging the company or by buy-backs; (4) the sale of shares to another investor; (5) the reorganization of the company; and (6) corporate liquidation.

**CGS Center:** There is a (new) movement towards corporate governance initiatives focused on non-listed companies, especially family owned companies. What are the reasons and the logic behind it?

**McCahery & Vermeulen:** It is certainly reasonable to infer that rules and principles that ensure 1) the basis for an effective corporate governance framework; 2) define the rights of shareholders and the responsibilities of management; and 3) set out guidelines for enhanced disclosure and transparency, could also improve the governance of non-listed firms. In fact, many of the 'best practice' rules and principles are imposed on non-listed firms by government, investors, insurance companies, lenders and others. This leads, however, to the question of whether such a 'one-size-fits-all' approach to corporate governance regulation is justified in economic and social terms. Consequently, a shift in the focus from publicly held companies to non-listed companies is important, because, the preponderance of firms worldwide are non-listed and ownership and control are usually not completely severed. Even though governance is but one of many determinants of investment and expansion decisions by firm owners and investors, there is little doubt that the core considerations affecting these decisions are operational and macro-economic. Still the changed economic environment in which firms operate makes them increasingly sensitive to governance issues. It is, therefore, necessary to obtain a better appreciation of the design and content of the legal governance framework of non-listed companies. National-oriented initiatives, which already emerged in Belgium and Finland, hold out the prospects of creating a dynamic and sustainable network of business practices and advice tailored to the needs of non-listed companies. In order to be effective, however, policymakers should draft coherent standards that are flexible, but specific

enough to provide meaningful guidance and practical solutions to a variety of non-listed companies. Moreover, the corporate governance recommendations should ideally contain guidelines as to when and how to use them.

**CGS Center:** Could you briefly highlight the importance of good governance from the perspective of related party transactions (IAS 24), and SPEs, for the benefit of the investors.

**McCahery & Vermeulen:** The Enron and Parmalat scandals illustrate the difficulty that auditors and regulators face in identifying related party relationships and transactions that are motivated by fraud or illicit earnings management. While there is widespread agreement on the need to regulate related party transactions, there is much less convergence on what transactions should be subject to deterrent regulation. The received wisdom is that related party transactions play an important and legitimate role in a market economy. For firms, trade and foreign investment is often facilitated by inter-company financing transactions. Lower costs of capital and tax savings provide a strong incentive for engaging in these transactions. Indeed, there are many examples of related party transactions that yield benefits for companies. By far the most popular transactions include (1) inter-company loans or guarantees from parent to foreign subsidiary; (2) the sale of receivables to a special purpose entity; and (3) a leasing or licensing agreement between a parent and a foreign subsidiary. A key concern about related party transactions is that they might not be undertaken at market prices but can be influenced by the relationship between the two sides of a transaction: there is a conflict of interest for some person in the company. For both controlling shareholders and insiders such as management, related party transactions can be the mechanism for extracting private benefits of control at the cost of other shareholders. We argued in the book that increased disclosure and transparency of related party transactions could prove effective in preventing the recurrence of Parmalat-style irregularities.

**CGS Center:** In addition to the discussions of the corporate governance practices of SWFs, we are now also discussing the role of government in corporate governance, given the developments like Trouble Assets Relief Programme (TARP) in US. What should US and EU do now? What safeguards are required for shareholders when governments do intervene?

**McCahery & Vermeulen:** When government is involved in a company as a shareholder we believe that they should take the interest of the stakeholders of the company into account (just like other shareholders). In a recent paper (Does the Takeover Bids Directive Need Revision? <http://ssrn.com/abstract=1547861>), we argue that corporate law was introduced to act as a facilitator, enabling managers and passive equity investors to move towards the optimal governance structure within a firm. It is widely acknowledged that corporate law's main features facilitate the separation of ownership and control, which is necessary to attract huge aggregations of capital needed to operate and expand a business. The law gives a

corporation legal entity status which makes it possible to shield a firm's assets from creditors of the firm's shareholders and managers. Moreover, corporate law's limited liability feature allows the investors, many of whom are wealth-constrained and risk-averse, to diversify their risks. Most importantly, corporate law offers a centralized management system through which passive and dispersed shareholders delegate important rights concerning control and policymaking matters to management. By doing so, it assigns to central management the obligation to conduct the business in a way that maximizes profits without jeopardizing social and economic welfare. Lawmakers have early recognized that these principles were necessary to give both investors and managers sufficient incentives to undertake relationship-specific investments in a listed corporation. As illustrated by this example, corporate law plays an interesting multifunctional role. First, it offers a governance structure that allocates ownership and control rights over the firm and its assets. Second, the corporate form operates as a gap-filling device. It assigns ex ante gap-filling authority to management, and defines and sets forth the rules of the game, taking trust, non-legal norms and reputation effects into account. Third, it reduces transaction costs, in that it assumes that without the legal framework the contracting parties are unable to contract into the coveted governance structure. Fourth, corporate law offers an incentive system in which a number of legal (contractual and statutory) and non-legal mechanisms interrelate so as to deal with the problems of motivation and coordination inside the firm. Governments, in their role as shareholders, should be careful not to disrupt the equilibrium by discriminatory and non-transparent actions.