San Jose Mercury News, Calif., Stocks.comment Column.
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Feb. 28-An old saying among venture capitalists offers a wonderfully cynical take on conflict of interest. "No conflict, no interest," they say. By that, they mean that if you were squeaky clean in eliminating every conflict, you would have no deals - and quickly, no business.

That crass motto surfaced again last week in conversations I had about alleged conflicts of interest at Cisco Systems and Sequoia Capital, Cisco's original venture capital backer.

Put very simply, this was a family affair. Cisco officials, including CEO John Chambers, invested in Sequoia partnerships. The Sequoia partnerships in turn invested in companies Cisco bought.

You don't have to struggle too hard to find conflict here. To the extent they are helping decide what companies to buy, Cisco executives want a low-ball bargain. To the extent they're investors in those startups, they might want the highest possible price. The question is whether that dilemma best serves shareholders.

In an apparent attempt to correct seedy appearances, top Cisco officials, including Chambers, have donated money they made from these deals to charity. In some cases, they recused themselves from voting on deals.

How smelly is this? First, it's worthwhile to point out what these arrangements are not. They are not Enron-style off-the-balance-sheet partnerships. They weren't designed by Cisco. They look more like high-octane mutual funds than secret slush accounts.

In the post-Enron days, there's an understandable tendency to lump every partnership together. Were Cisco officials making money on the side? Well, yes, at least sometimes. Did some acquisitions flop? Well yes, again. And was Sequoia co-founder Don Valentine on the Cisco board? Yes. Nothing more needed: Hang 'em high.

But it isn't quite that simple. The indictment isn't quite that direct. And it's worth understanding the nuances, because this story is fundamentally about profitable nuances.

What we're talking about is a phenomenon called "side funds," which VCs set up as a way to cement loyalty with the top executives of Silicon Valley. Virtually every valley CEO is in one, sometimes in several. They invest alongside the big pensions or universities that make up the venture fund's ordinary clientele.

Until recently, CEOs benefited quite nicely from this, raking in the 40 or 50-percent returns at the elite firms. In turn, the venture capitalists had someone they could turn to when they had to check out the credentials of an executive they wanted to fund - as well as a loyal stable of bright entrepreneurs who might bring fresh deals to the VC's.

To get an accurate gauge on what side funds mean, I called Gary **Morgenthaler** , a partner in **Morgenthaler** Ventures, one of the more upstanding VCs in the valley.

Morgenthaler Ventures doesn't offer side funds per se - and avoids taking investments from executives who might face a conflict.

"It's pretty indirect," said **Morgenthaler** of the conflict. "I guess I'd call this soft money, like in Washington D.C. Essentially, it buys you access, but not policy."

I think the point is a shrewd one. The venture capitalists, the ultimate networkers in the valley, want to have the ear of John Chambers or (ex-veep) Don Listwin when they need it. And they're willing to give them a slot in a side fund to ensure it.

Does this buy a decision? Did Chambers, to take one example, vote for the acquisition of Monterey Networks because it held the possibility of a return to him through a Sequoia partnership? (He later donated the $10,000 profit to charity). I don't think so. Chambers is so wealthy that this kind of money barely counts as a tip.

"Most execs are in side funds of many (VC) funds," says one valley executive who asked to remain anonymous. `I'm in several myself. To tell you the truth, we don't know when investment decisions are made. Chambers probably has as much invested through side funds in companies whose mission it is to destroy Cisco - and he doesn't even know about it."

But if the decisions aren't necessarily bought, it is worthwhile for investors to know about the seamy loose ends of this system. You can't argue that VCs do this just because they like the personality of the entrepreneur. In politics, access counts. And the same is true in business.

Charles Elson, the director of the Center for Corporate Governance at the University of Delaware, points out that anytime an executive is on two sides of an issue, it's a potential problem. Sure, there are ways to make it fairer to the company. But fundamentally, Elson argues, it's simpler to avoid the conflict altogether. Do top execs really need to be in the side funds? A few people argue that conflict is good, that in this case it allows Chambers to see upcoming companies and how they're doing.

My guess is he doesn't need to invest in a Sequoia side fund for that. He could solve the conflict by avoiding the investment.

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