SILICON VALLEY / SAN JOSE
Business Journal

VCs see tighter federal rules as threat

By Sarah Lacy
SILICON VALLEY/SAN JOSE BUSINESS JOURNAL
Updated: 8:00 p.m. ET June 27, 2004

Venture capitalists have watched while a series of well-intended federal regulations—from stock options to corporate governance—have nibbled away at business. Now that VC-backed companies are starting to go public again, they're realizing just how much of a "perfect storm" has been created, threatening to hobble entrepreneurs and depress returns. And the VCs are getting angry.

Earlier this month, at a well-attended venture capital conference in San Francisco, Gary Morgenthaler appeared to be sitting in a chair on stage. In actuality, he was standing on a soap box.

Appearing on a panel with other veteran venture capitalists the tone was upbeat, until the mild-mannered general partner of Morgenthaler Ventures changed the subject to recent legislation meant to curb the kinds of corporate scandals rampant in the last few years. While multi-billion businesses were getting flesh wounds, small businesses—venture-backed or otherwise—have become the victim of more devastating friendly fire, he said.

He laid out criticisms of the Accounting Standards Board's move to expense stock options, the hidden costs of Sarbanes-Oxley and repercussions of a genuine Chinese wall being erected between investment banking and research on Wall Street. The first two are making it considerably harder and more expensive for small companies to go public and the last one is resulting in little analyst coverage once they get there. Collectively, that means worse returns for the venture industry and lessened incentives for entrepreneurs to start companies. As for successful startups, acquisitions are looking more and more attractive—a big reversal from the way the industry has always worked.

"It's very worrisome," Mr. Morgenthaler said, in his usual calm, quiet manner. "This is well meaning legislation and private equity isn't the intended target, but they are the victims."

When he was done speaking, he was met with silence.

"Well said," added Dick Kramlich, founding general partner of New Enterprise Associates.

Mssrs. Kramlich and Morgenthaler are just two of the many venture capitalists exhausted and incensed at hastily approved legislation.

The worst offender, to them, is FASB. It's no surprise the move to expense stock options is the biggest hot button of the three for most venture capitalists. Indeed, all of Silicon Valley has been up in arms whenever the subject comes up—and it took center stage June 24 at a FASB public roundtable.

Many VCs agree that the movement is seeking to solve a legitimate problem. It is a form of compensation and isn't free. But treating options as an expense on the balance sheet isn't the way to solve it, they say.

Investors make a myriad of arguments. The earnings per share metric already takes the issuance of more shares into account, so expensing them on the balance sheet is double counting, Mr. Morgenthaler says. Also, FASB's proposal would value the amount of the cost on how much the stock is worth at any given time. That's fine for companies like Coca-Cola that have steady, predictable revenue streams, but in the startup world, a single customer win could greatly affect the company's fortunes. Having to revalue stock options quarter to quarter, then expense them on the balance sheet will lead to wild fluctuations, making quarter-to-quarter comparisons difficult, he says.

Instead, options should be expensed according to what they cost the company, not what the employee will gain by exercising them at any given time, says Nancy Schoendorf, general partner at Mohr, Davidow Ventures. They only cost the company the money it could have raised by issuing those shares in the market at that time—a set figure.
"It's so wrongheaded, I am frankly mystified that the accounting priesthood has seized on this as a presumed issue of accounting purity," Mr. Morgenthaler says.

"It's like putting a tourniquet around your neck to stop your foot from bleeding," says Nick Sturiale, general partner at Sevin Rosen Funds.

Big tech companies like Sun Microsystems, Intel, and Cisco are fighting this just as hard, but if the new rules are approved, they have the wherewithal to just give more cash compensation. Startups don't, making recruitment and retention a hardship. And the balance sheets will be so convoluted, going public will be more difficult, investors say, with results less impressive.

At the same time, that difficulty is already getting compounded by Sarbanes-Oxley, a drain on time and money—two things many startups are perennially short on. Sarbanes-Oxley, a broad-based law to enforce greater corporate governance, mandates composition of company boards and sets new standards for filing and auditing Securities & Exchange Commission documents, among other things.

It's upped the cost of being a public company by over $2 million a year, some estimate. That may not be much to a $1 billion company, but to a startup, that substantially eats into revenue and cash flow.

"This came from two congressmen trying to get their name in the paper," Mr. Morgenthaler says. "It was never intended for small businesses, but no one was thinking about the impact on small business when it was passed."

And it makes it harder to get good people to serve on boards. Venture investors are increasingly getting off boards as soon as the companies go public, even though they know the companies well and often have industry contacts that could help close sales, says Mark G. Heesen, president of the National Venture Capital Association.

The bill also contains qualifications certain board members have to have, meaning some of these investors have to step down whether they want to or not.

"What ends up happening is you have to restructure the board and investors who have been with the company from the very beginning have to leave and be replaced with people that have no history with company," says Ken Lawler, general partner at Battery Ventures. "By definition, you end up with weaker board."

Mr. Lawler has two startups ready to go public, and Sarbanes-Oxley alone is delaying it until at least the first quarter of next year. He only hopes the window isn't closed by then.

"It has the potential to be quite devastating," he says.

Assuming those companies can go public, new rules governing research and investment banking may make the stocks less liquid. Before, banks could fund equity research with fees from investment banking. Because of rampant conflicts of interest, equity research must now be paid for with revenues from trading. But large cap stocks are the ones that generate most trading revenue. The result has been that more than three-fourths of stocks under $200 million in market capitalization are getting no research coverage at all, while more than 40 analysts cover Cisco Systems, Inc.

Unlike the stock option debate, Sarbanes-Oxley and the new investment banking rules were issues VCs didn't fume about when they first were enacted.

"That was before they got the bill," Mr. Sturiale says.

It also had to do with the timing.

"You have to go back to the environment then," Mr. Heesen says. "We were in the midst of Enron and WorldCom. You couldn't publicly say anything about this sacred law without being labeled by the press, frankly, as being against corporate governance. There was no way to stop that train."

And Mr. Heesen doesn't expect any changes before the election. Post-November, he is hopeful there will be some legislation easing the Sarbanes-Oxley burden on smaller companies. As for stock options, he says the debate isn't over. The House is now considering a bill that would restrict expensing of options to the top five executives of a company. He hopes for it to be a wake-up call to FASB.

If not, the kind of returns the venture industry has historically reaped may be endangered, as acquisitions become increasingly more attractive than IPOs. That, too, will hurt Silicon Valley's economy, which stands to gain more from new stand-alone companies being formed than acting as outsourced R&D for existing tech titans.

To Mr. Morgenthaler, it's a battle worth fighting and he encourages his fellow investors to be more vocal.
"Never underestimate the venture community," he says. "We are a smart and resourceful group of people that once mobilized can create a powerful lobbying force and really affect the outcomes."