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Public or Private Venture Capital?

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Editor's Note: Darian M. Ibrahim is Professor of Law at the William & Mary Law School. This post is based on a recent **paper** authored by Professor Ibrahim.

In the United States, high-growth startups raise funds privately from angel investors and venture capital funds (VCs). Other countries, without the robust supply of angel and VC funding found in the U.S., have resorted to public markets to supply startups with venture capital. These junior stock exchanges, or *public venture capital*, have not been successful at replicating the U.S. private venture capital success, however.

Three of the most notable attempts at public venture capital have been London's Alternative Investment Market (AIM), Germany's Neuer Markt (NM), and Hong Kong's Growth Enterprise Market (GEM). While other countries have also attempted to establish public venture capital, the AIM, NM, and GEM are the most notable efforts. They also offer differing approaches to regulation and outcomes, making for fruitful academic study. Further, the AIM, NM, and GEMs' small size and express intention to supply growth capital to startups makes these junior stock exchanges the apt comparison to Silicon Valley, not the Nasdaq, though they were initially touted as a rival to the latter.

My new paper **Public or Private Venture Capital?** explores the AIM, NM, and GEM and examines why none of them has successfully served as a stepping stone to that country's senior stock exchange (our Nasdaq or NYSE). For startups to attract venture capital, from either public or private investors, they must solve two major problems. First, *ex ante* investment, investors must mitigate *information asymmetry*, or that entrepreneurs know more about their businesses than investors do. Second, *ex post* investment, investors must reduce *agency costs*, or the risk that entrepreneurs can mismanage or use investor funds for personal gain.

Due to startups having sparse track records and technological uncertainty, information asymmetry and agency costs exist in extreme form in startup investing. This paper offers a contrast in dealing with these problems. The U.S. approach is to tackle them through private ordering and informal mechanisms. VCs and more sophisticated angels fund startups in stages, which reduces information asymmetry directly by allowing investors to learn more about startups before the next funding round, and reduces information asymmetry indirectly by allowing entrepreneurs to credibly signal that the next milestone will be reached and further financing will flow. Informally, angel and VC investing are characterized by an intense geographic component, which means the investor or someone they know and trust likely knows the entrepreneur and her business. Angels and VCs do not typically invest in unknown quantities.

Lacking the ability to address information asymmetry and agency costs in the same ways, the public venture capital approach relies on corporate and securities law, similar to our public markets for established companies. Although the public approach works for established companies, it cannot solve the exacerbated nature of the risks present in startup investing. The NM mandated very strict disclosure, but was still plagued by fraud and shut down five and a half years after it opened. The AIM relies on reputational capital in the form of Nominated Advisors (Nomads) who vouch for startups, but these can only do so much, especially with insufficient monitoring or conflicts of interest.

Having put its thumb on the scale in favor of private venture capital, my paper lastly argues that the U.S. took an ill-advised step toward following the public venture capital model when it legalized crowdfunding in the Jumpstart Our Business Startups (JOBS) Act of 2012. Crowdfunding initially resembled in important ways the design of the NM, with an unsophisticated investor base and heavy disclosure requirements. Funding portals, or the websites listing crowdfunding opportunities, mimicked the junior stock exchange itself. In a fortuitous turn, however, the SEC's final implementing rules in 2015 (Regulation Crowdfunding) reversed course and moved toward the private model by allowing funding portals to curate, or screen, which startups are allowed to list on their sites. This expert curation reduces information asymmetry for the crowd, thus allowing them to tag along to higher-quality investments.

The complete paper is available **here**.