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Nontraditional Investors

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Nontraditional Investors

Jennifer S. Fan[*]

In recent years, nontraditional investors have become a major player in the startup ecosystem. Under the regulatory regime of U.S. securities law, those in the public realm are heavily regulated, while those in the private realm are largely left alone. This public-private divide, which is a fundamental organizing principle of securities law, has eroded with the rise of nontraditional investors. While legal scholars have addressed the impact of some of these nontraditional investors individually, their collective impact on deal terms, deal timelines, due diligence, and board configuration has not been discussed in a holistic manner; neither has their impact on the investor landscape and securities law. This Article provides the first descriptive account of nontraditional investors throughout startups' lifecycles and the normative implications of their participation in the venture capital ecosystem. Ultimately, nontraditional investors helped to facilitate the rise of unicorns which contributed to the "breakdown" of the public-private divide, with the attendant problems related to investor protection, corporate governance, valuation bubbles, and the like. Once thought of as outliers, nontraditional investors have influenced the venture capital market and the ways in which deals were conducted in significant ways. They drove capital investment trends and created an increasingly competitive deal environment in venture capital. Outsized funds became the norm, and the size and valuation of venture capital deals at each stage of a startup grew ever larger. In some cases, it led to less investor oversight and due diligence. Although one of the hallmarks of venture capital investors is their hands-on approach, that is not the case for all of the nontraditional investors. Board dynamics and economics and control—the two underlying principles of venture capital deals—shifted in favor of the founders as nontraditional investors proliferated and the economy remained strong. However, the recent economic downturn has led to a recalibration of nontraditional investors'

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influence. In this environment, founders are no longer able to dictate the terms of venture capital financings, the investment pace has slowed, and while some nontraditional investors may retreat and reassess, their influence in the venture capital ecosystem will continue to reverberate in the years to come.

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INTRODUCTION

For many years, commentators have predicted a crash in the frothy startup space.[1] With the exception of a slight dip during the pandemic, the valuations and numbers of venture capital-backed startups continued their dizzying rise.[2] Ultimately, the pandemic drove the demand for tech services to new heights.[3] Low interest rates and the increasing value of public tech stocks also led money managers to venture capital investments in this sector.[4] In Silicon Valley, traditional firms face competition from "[r]elative newcomers[, who] are inking deals at a torrid pace, often winning with speed, pricing and flexible investment terms. That's made the market for investing in tech startups much bigger."[5]

Previously, investors in venture capital financings that were outside the traditional venture capital firm realm were called "tourist investors."[6] However, this appears to be a misnomer because these

1. In 2015, Bill Gurley, a partner at Benchmark, warned that leaner times were ahead for startups; previously, he had forecast "dead unicorns." Carmel DeAmicis, *Bill Gurley to Unicorns: Winter is Coming. You Ready?*, VOX (Aug. 20, 2015, 11:30 PM), https://www.vox.com/2015/8/20/11617902/bill-gurley-to-unicorns-winter-is-coming-you-ready [https://perma.cc/AUX7-PXW9]. Bill Gurley (@bgurley), TWITTER (Aug. 20, 2015, 8:46 PM), https://twitter.com/bgurley/status/634572345240240129 (Bill Gurley's first Tweet in series related to "tweetstorm").

2. PITCHBOOK DATA, INC. & NAT'L VENTURE CAPITAL ASS'N, VENTURE MONITOR: Q3 2021 7 (2021), https://nvca.org/wp-content/uploads/2021/10/Q3_2021_PitchBook-NVCA_Venture_Monitor.pdf. [https://perma.cc/23VH-WLU7] [hereinafter VENTURE MONITOR: Q3 2021]. According to a Silicon Valley Bank analysis, this environment has also led to ever-larger funds with "[f]unds of more than $1 billion represent[ing] 47% of U.S. VC fundraising—28 percentage points higher than in 2015." Rob Freelen, *SVB Q&A: The Future of VC: Solo Capitalists and Global Venture Firms Grab Larger Stakes*, SVB (Oct. 14, 2021), https://www.svb.com/blogs/rob-freelen/svb-qa-the-future-of-vc-solo-capitalist-and-global-venture-firms [https://perma.cc/2EQY-NW3D].

3. Kate Clark, *SoftBank, Insight Top List of 10 Fastest-Growing Tech Investors*, THE INFO. (Aug. 4, 2021, 10:01 AM), https://www.theinformation.com/articles/softbank-insight-top-list-of-10-fastest-growing-tech-investors?rc=j8xyfa [https://perma.cc/R3VB-2S84].

4. *Id.*

5. Berber Jin, *Benchmark's VC Model Strained by Newcomers, Supersize Rivals*, THE INFO. (June 28, 2021, 6:01 AM), https://www.theinformation.com/articles/benchmarks-vc-model-strained-by-newcomers-supersize-rivals?rc=j8xyfa [https://perma.cc/U362-SVBD].

6. *New Participants in VC Will Continue to Proliferate*, PITCHBOOK BLOG (Jan. 30, 2019), https://pitchbook.com/blog/new-participants-in-vc-will-continue-to-proliferate [https://perma.cc/AJV7-72HK] ("We use the term "tourist investors" . . . referring to essentially anyone outside of VC firms (including corporations, LPs, PE firms, sovereign wealth funds, hedge funds, investment banks, etc.)."). They are sometimes called "crossover funds" as well. Connie Loizos, *Investors Are Turning Their Focus Away from Private Shares to Public Stocks, Says*

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investors are not just visitors to venture capital investing; they are here to stay. A more apt term for these investors who are impacting the venture capital ecosystem in perhaps unexpected ways is "nontraditional investor." Nontraditional investors fall into a few categories:[7] corporate venture capital,[8] private equity,[9] mutual fund,[10] and sovereign wealth fund.[11] There is also the relative newcomer to the scene: the solo venture capitalist where the fund is managed by one person.[12] These nontraditional investors have brought significant change to the startup realm and have contributed to the "breakdown" of the public-private divide, a regulatory scheme under U.S. securities law "which separate public companies, public capital, and public markets, from private companies, private capital, and private markets." [13] The year 2021 was a record year for fundraising across multiple metrics for

Crossover Investor, TECHCRUNCH (Jan. 27, 2022, 3:59 PM) https://techcrunch.com/2022/01/27/crossover-investors-are-turning-their-focus-to-public-stocks-says-crossover-investor/ [https://perma.cc/G35S-MS2H]. Aidan Ryan, *The Biggest Winners of Pre-IPO Funding Rounds*, THE INFO. (Feb. 4, 2022, 6:36 AM), https://www.theinformation.com/articles/the-biggest-winners-of-pre-ipo-funding-rounds?utm_content=article-7194&utm_source=sg&utm_medium=email&utm_campaign=article_email [https://perma.cc/P4DD-DGSQ].

7. Angel investors, who are wealthy accredited investors, are not discussed as nontraditional investors since they have a long history in venture capital and have a body of scholarship specific to them. *See, e.g.*, CFI Team, *Angel Investor: The Holy Grail for Startups*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/what-is-angel-investor/ [https://perma.cc/GMP9-LM5E] (Apr. 27, 2020). They also do not invest at the dollar amounts that the nontraditional investors do. *See, e.g.*, Erin Griffith, *Even Your Allergist Is Now Investing in Start-ups*, N.Y. TIMES (Aug. 9, 2021), https://www.nytimes.com/2021/08/09/technology/angel-investors-startups.html [https://perma.cc/XZH9-Q6JS]; VENTURE MONITOR: Q3 2021, *supra* note 2, at 7.

8. Jennifer S. Fan, *Catching Disruption: Regulating Corporate Venture Capital*, 2018 COLUM. BUS. L. REV. 341 (2018).

9. *See* discussion *infra* Section I.C.

10. *See* discussion *infra* Section I.D.

11. VENTURE MONITOR: Q3 2021, *supra* note 2, at 7.

12. This type of investor will also be discussed because historically there have not been solo venture capitalists. Berber Jin, *Solo VC Lachy Groom Raises $250 Million for Third Fund,* THE INFO., https://www.theinformation.com/briefings/b5db02 [https://perma.cc/7BTG-MNBY] (last visited Sept. 28, 2022). Solo venture capitalists have also been called "solo capitalist." Nikhil Basu Trivedi, *The Rise of the Solo Capitalists,* NEXT BIG THING (July 8, 2020), https://nbt.substack.com/p/the-rise-of-the-solo-capitalists [https://perma.cc/X85Z-K7PS].

13. George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J. L. & BUS. 221, 224 (2021) (analyzing how changes in securities law "reveals that the public-private divide is no more"); *see also* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013) (introducing the idea of the public-private divide and when a private enterprise should be required to take on public status).

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startups.[14] In the first half of 2021 alone, nontraditional investors invested $116 billion into startups—almost matching the total for all of 2020.[15] By the end of 2021, nontraditional investors created $253.8 billion in deal value with an estimated 6,483 deals; this was nearly double the deal value of the year before.[16] Over 4,000 nontraditional investors did at least one deal within the U.S. market in 2021.[17] In fact, five nontraditional investors made 100—or more—deals, including Tiger Global Management ("Tiger") and SoftBank.[18] Some nontraditional investors, specifically "hedge funds, mutual funds and private equity firms, . . . are playing a bigger role in startup deal making. Asset managers and private equity firms surpassed corporations as accounting for the largest proportions of US deal value with nontraditional investor participation . . . ."[19] In a survey done by Silicon Valley Bank in the first quarter of 2022, more than 80% of venture capital and private equity firms reported that they planned to raise more capital with the top quartile of firms doing so less than a year since

14. *See generally* VENTURE MONITOR: Q3 2021, *supra* note 2. In 2021, $329.8 billion was raised in U.S. venture capital investment—almost double the amount in 2020. James Thorne, *A Hot VC Market Gave Us Theranos. Today's Bigger Boom Could Bring Us More of Them*, PITCHBOOK (Jan. 9, 2022), https://pitchbook.com/news/articles/Theranos-guilty-verdict-startups-venture-capital-silicon-valley [https://perma.cc/XE7M-TA3U].

15. Marc Vartabedian, *Asset Managers Help Supercharge Venture-Capital Sector*, WALL ST. J. PRO (July 14, 2021, 6:00 AM), https://www.wsj.com/articles/asset-managers-help-supercharge-venture-capital-sector-11626256800?mod=article_inline [https://perma.cc/B47H-QDKC] [hereinafter *Asset Managers*]. In 2020, approximately 77% of U.S. VC deals by market value included a nontraditional investor. Thorne, *supra* note 14.

16. PITCHBOOK DATA, INC. & NAT'L VENTURE CAPITAL ASS'N, VENTURE MONITOR: Q4 2021 25 (2021), https://nvca.org/wp-content/uploads/2022/01/Q4_2021_PitchBook_NVCA_Venture_Monitor-1.pdf [https://perma.cc/3PAP-DLXE] [hereinafter VENTURE MONITOR: Q4 2021]. As a point of comparison, nontraditional investors participated in 3,948 deals for a total of $126.9 billion in 2020 and 3,878 deals for a total of $98.8 billion in 2019. *Id.*

17. KYLE STANFORD, Q2 2022 ANALYST NOTE: NONTRADITIONAL INVESTORS REACT TO CURRENT MARKET HEADWINDS 2 (2022), https://pitchbook.com/news/reports/q2-2022-pitchbook-analyst-note-nontraditional-investors-react-to-current-market-headwinds [https://perma.cc/PW7H-B3UU]. "More than 4,400 unique nontraditional investors made at least one deal in 2021, 33.4% higher than the previous record from 2020. For comparison, prior to the [great financial crisis], just 1,300 nontraditional investors were active in the US VC market." *Id.* at 8.

18. *Id.* "Tiger Global's near 200 deals during 2021 will likely go down in history as one of the fastest deployments from a private fund . . . SoftBank and Tiger Global, among others, put more capital to work during 2021 than many around the industry thought possible." *Id.* at 2.

19. Vartabedian, *Asset Managers*, *supra* note 15.

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their prior raise.[20] Experts predict that the number of nontraditional investors will only increase in the coming years.[21] Since 2016, deals led or solely financed by hedge funds and mutual funds have increased nearly every year.[22]

The rise of nontraditional investors has not come without consequences, however. Technology companies' poor public market performance is now impacting venture capital investing.[23] An economic downturn—some might say an overdue one—is here[24] and likely will not be short-lived.[25] Some have opined that the combination of unsustainable valuations, COVID-19, the war in Ukraine, and inflation have led to the current tech downturn;[26] cheap money and the absence of legal guardrails in the private tech

20. SILICON VALLEY BANK, GLOBAL FUND BANKING OUTLOOK: EMERGING TRENDS AND INSIGHTS FOR THE PRIVATE EQUITY AND VENTURE CAPITAL ECOSYSTEMS Q1 2022 8 (2022), https://www.svb.com/globalassets/trendsandinsights/reports/global-fund-banking-outlook/q1-2022/gfb_outlook_q1_2022.pdf?tpcc=nltermsheet [https://perma.cc/U8KH-F4GV].

21. VENTURE MONITOR: Q4 2021, *supra* note 16, at 25.

22. STANFORD, *supra* note 17, at 4.

23. Jessica Bursztynsky, *Start-Up Investors Are Warning of Dark Days Ahead as Boom Times Are 'Unambiguously Over*,' CNBC (May 28, 2022, 9:00 AM), https://www.cnbc.com/2022/05/28/start-up-investors-issue-warnings-as-boom-times-unambiguously-over.html [https://perma.cc/349A-KZN3]. Michelle Celarier, *The IPO Market Is on Track for Its Worst Performance in 30 Years*, INST. INV. (Sept. 30, 2022), https://www.institutionalinvestor.com/article/b2009nj9bsgzd8/The-IPO-Market-Is-on-Track-for-Its-Worst-Performance-in-30-Years [https://perma.cc/J38U-C9ZB].

24. One indicator of an economic downturn is the state of the IPO market. Stock market listings in the U.S. have declined precipitously with current indicators suggesting that "2022 is on track to be the worst year for U.S. listings since 2009, with IPOs having raised roughly $5 billion in the first seven months this year - a 96% decline from the same period in 2021." *Factbox: U.S. IPO Activity Plunges as Ukraine War Triggers Volatility*, REUTERS (Aug. 10, 2022, 8:57 AM), https://www.reuters.com/business/us-ipo-activity-plunges-ukraine-war-triggers-volatility-2022-08-10/ [https://perma.cc/F2M3-J9S2]. *Cf.* Q3'22 VENTURE PULSE REPORT—UNITED STATES (2022) https://home.kpmg/xx/en/home/campaigns/2022/10/q3-venture-pulse-report-united-states.html?tpcc=nltermsheet [https://perma.cc/7HFW-BDF3] (noting that although corporate venture capital has historically decreased during economic downturns, early indicators suggest that some sectors remain robust, such as energy and financial services).

25. Brad Stone & Lizette Chapman, *The Tech Rout Isn't Just Cyclical—It's Well-Earned, and Overdue*, BLOOMBERG (May 25, 2022, 10:01 PM), https://www.bloomberg.com/news/features/2022-05-26/meta-amazon-tesla-big-tech-s-stock-selloff-is-long-overdue [https://perma.cc/FU36-SF3T]. Partners from Lightspeed, a venture capital firm, opined, "The boom times of the last decade are unambiguously over." *The Upside of a Downturn*, LIGHTSPEED (May 16, 2022), https://medium.com/lightspeed-venture-partners/the-upside-of-a-downturn-9219ea4b26a2 [https://perma.cc/L5ND-C66J].

26. *See* Stone & Chapman, *supra* note 25.

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company sector also helped to contribute to this current situation. Sequoia Capital has referred to this time as a "Crucible Moment."[27]

For the first time, nontraditional investors will invest more in private tech startups than traditional venture capital firms.[28] They are continuing to invest in startups at a record-breaking pace; through the third quarter of 2021, they had already broken the previous year's record, leading 1,790 deals.[29] PitchBook, a financial data and software company, predicted that nontraditional investors would lead more than 2,000 deals in 2022.[30] Late-stage venture capital investments have been especially lucrative for nontraditional investors.[31] One recent study analyzing the thirty largest U.S. companies—according to market capitalization—to go public over a four-year period showed that "[w]hile the average share price for these 30 companies has risen 484% above the price they offered investors in their last private financing, the current average share price has fallen 6% from when the stocks first publicly listed."[32] As one commentator noted, "venture capital as we know it is ending."[33] The proliferation of all of these new players had significant implications for deal terms and startup corporate governance. In particular, it impacted the board and further created an imbalance between the power that founders wield versus investors.[34] It also potentially created additional conflicts of interest. Furthermore, the cross-investments between private funds

27. Roelof Botha, Kevin Kelly, Jeff Wang, Doug Leone, Alfred Lin & Carl Eschenbach, *Adapting to Endure*, SEQUOIA CAPITAL (May 2022), https://s3.documentcloud.org/documents/22036831/adaptingtoenduremay2022.pdf [https://perma.cc/E8LE-ZVDH].

28. Sam Lessin, *The End of Venture Capital as We Know It*, THE INFO. (Aug. 4, 2021, 6:01 AM), https://www.theinformation.com/articles/the-end-of-venture-capital-as-we-know-it?rc=j8xyfa [https://perma.cc/J2J3-8SPS].

29. Joshua Chao, *2022 U.S. Venture Capital Outlook,* PITCHBOOK 19 (Dec. 17, 2021), https://files.pitchbook.com/website/files/pdf/PitchBook_Analyst_Note_2022_US_Venture_Capital_Outlook.pdf [https://perma.cc/6RDZ-FT54] [hereinafter *2022 U.S. Venture Capital Outlook*].

30. *Id.* Note that this prediction may change in light of the economic downturn.

31. Aidan Ryan, *The Biggest Winners of Pre-IPO Funding Rounds*, THE INFO. (Feb. 4, 2022, 6:36 AM), https://www.theinformation.com/articles/the-biggest-winners-of-pre-ipo-funding-rounds?utm_content=article-7194&utm_source=sg&utm_medium=email&utm_campaign=article_email [https://perma.cc/P4DD-DGSQ].

32. Twenty-four of the thirty companies were trading at above the share price that they were sold at in the last private round of financing, but only twelve of them were trading above their IPO price. *Id.*

33. Lessin, *The End of Venture Capital*, *supra* note 28.

34. Jennifer S. Fan, *The Landscape of Startup Corporate Governance in the Founder-Friendly Era*, 18 N.Y.U. J. BUS. L. 317 (2022).

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and mutual funds, which were largely not subject to regulatory scrutiny due to various exemptions under securities law, played a part in the breakdown of the public-private divide.

This Article contributes to the growing body of scholarship on private companies in the startup ecosystem.[35] It provides an original descriptive account of nontraditional investors and illustrates how board dynamics have shifted as a result.[36] The entrance of these key players into the startup scene has impacted the composition of boards of directors and how influential each board member can be. This has implications for our understanding of how startups operate, particularly with respect to corporate governance, during good economic times.

In good economic times, startup investors faced an increasingly competitive market from a startup's inception—not just in the later stages if they became unicorns—because of the amount of money nontraditional investors placed into startups. This created a situation where capital was abundant and founders had many potential investors to choose from. Founders were in the driver's seat and could dictate deal terms and valuation.[37] As a result, they typically exert more control on the board as well. In fact, both economics and control—two principal elements of venture capital financings—increasingly lay with founders before the economic downturn. The pace of deal making was also faster and affected the quality of due diligence being done at the startups.[38]

35. *See, e.g.*, Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019); Robert Bartlett, Robert P. Bartlett & Eric Talley, *Law and Corporate Governance, in* 1 THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 177, 185–86 (Benjamin E. Hermalin & Michael S. Weisbach eds., 2017); Robert P. Bartlett II., *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 37 (2006).

36. An earlier article focused on nontraditional investors (referring to them as alternative venture capital) but only in the unicorn context and did not refer to solo venture capitalists. *See* Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 88 TENN. L. REV. 983 (2020).

37. "[F]ounders have gained more ability to control their companies . . . . Based on their needs, founders can build their capitalization table with the type of investor they prefer—and do so in record time . . . . Top entrepreneurs . . . often have their choice of firms, valuation, and terms." Freelen, *supra* note 2. "Over the years, deal dynamics have tilted in favor of founders, a change that can be gauged by the supply and demand of capital as well as the use of deal terms that illustrate the investor-founder relationship." Thorne, *supra* note 14.

38. According to Professor Margaret O'Mara, "The hubris and bluster and sometimes unethical (and occasionally criminal) behavior [in Silicon Valley] hasn't gone away, but has increased in volume as the scale, speed, wealth and hype of the tech world—and those companies that identify as tech companies—has gotten greater[.]" David Streitfeld, *In Silicon*

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However, when the market slumps, investors act with more prudence and look to see which startups have been careful with their cashflow and which ones have put corporate governance mechanisms into place as they developed.

Recently, there has been a flurry of scholarship on startups, particularly unicorns.[39] While the scholarship is wide-ranging, many articles that focus on the investors in startups typically limit their discussions to traditional venture capital firms, with only a quick note on nontraditional investors or a focus on one type of nontraditional investor.[40] But this Article is the first to comprehensively analyze nontraditional investors and the role they play throughout startups' life cycles.[41]

This Article expands the scholarship's current focus on understanding venture capital deals, and startup corporate governance in particular, beyond the lens of traditional venture capital firms to include the role of nontraditional investors in this realm. In doing so, it makes three main contributions. First, it provides the first descriptive account of the breadth of nontraditional investors in venture capital financings throughout a startup's life cycle. Specifically, it offers a taxonomy of the different investor types. Second, the Article makes a normative contribution, illustrating how the rise of these nontraditional investors impacted deal terms, deal timelines, due diligence, and startup corporate governance during good economic times; it will also highlight what such investors' influence is like during economic downturns. Furthermore, the advent of nontraditional investors has contributed to a breakdown in the public-private divide and illustrates that the

Valley, Criminal Prosecutors See No Evil, N.Y. TIMES (Sept. 7, 2021), https://www.nytimes.com/2021/09/07/technology/silicon-valley-prosecutions.html [https://perma.cc/PJ93-5UKF].

39. Unicorns are private companies with a valuation of $1 billion or more. Fan, *Catching Disruption*, *supra* note 8. *See, e.g.*, Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165 (2017); Alon-Beck, *supra* note 36.

40. *See, e.g.*, Pollman, *Startup Governance*, *supra* note 35, at 175–76 (mentioning nontraditional investors briefly); Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341 (2017) (analyzing mutual funds specifically).

41. Some scholars have analyzed the role of nontraditional investors in the unicorn context. *See, e.g.*, Alon-Beck, *supra* note 36, at 1004 (Nontraditional investors "invest in late stage and very late-stage IDEs and are very different from traditional VC investors."). However, as this Article will illustrate, the role of nontraditional investors is impacting startups from their inception and while they differ from traditional venture capitalists in some ways, they also share some commonalities.

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existing structure of securities laws, and its embedded investor protections, are ill-suited to address challenges in the current investor landscape. Third, this Article shows how traditional venture capital firms themselves are changing to adapt to an increasingly competitive environment. This has implications for how financings are structured and understood from a legal perspective. The current framework in the academic literature assumes that the investor is a traditional venture capital firm with the same expectations that such firms have always had—board seats for the lead investor, a certain percentage of ownership in the company in return for the investment, and particular pro rata rights, among other things. However, the influx and sheer numbers of nontraditional investors, along with the legal and structural changes in some of the most prominent traditional venture capital firms, means that the framework needs to be revised to accommodate such changes.

The paper proceeds as follows. Part I discusses the current landscape of investors in venture capital financings, including the traditional venture capital firm as a point of comparison for the nontraditional investors. It then provides a taxonomy of the different types of nontraditional investors and each one's general approach to venture capital financings and corporate governance. Part II examines how nontraditional investors impact venture capital financings and startup corporate governance. In addition, this Part will show that the delicate balance between founders and investors has been complicated by the increased presence of nontraditional investors at every stage of the venture capital financing process. From a broader perspective, it will also analyze how nontraditional investors helped to facilitate the rise of unicorns with very little regulatory oversight, which in turn contributed to the breakdown of the public-private divide with its attendant problems related to investor protection, corporate governance issues, valuation bubbles, and the like. Part III looks to the future and offers the normative implications of the crowded field of investors for the traditional venture capital investors and how they impact the existing analytical framework. It then suggests potential areas for reform.

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I. INVESTORS IN VENTURE CAPITAL FINANCINGS

Venture capital is an important driver of economic value.[42] It is "a form of financing where capital is invested into a company, usually a startup or small business, in exchange for equity in the company."[43]

In the venture capital landscape, investors other than the traditional venture capital firm have proliferated. In 2020, nontraditional startup investors increased by nearly 12% from 2019 for a total of almost 4,000 deals.[44] This has significant implications from a legal perspective as these new players have shifted the rules of the venture capital game. This Part will discuss the different types of investors and the roles that such investors play in startups along with their legal structures. The Article begins by discussing the traditional venture capital firms as well as the venture capital funds out of which they invest. It then proceeds to discuss corporate venture capitalists, private equity investors, asset managers, sovereign wealth funds, and solo venture capitalists.

A. Venture Capital Firms

Historically, startups have sought money from the traditional venture capital firm. "Venture capital firms are a type of investment firm that fund and mentor startups or other young, often tech-focused companies."[45]

42. "Consider that in 2015 public companies that had received VC backing accounted for 20% of the market capitalization and 44% of the research and development spending of U.S. public companies." Paul Gompers, Will Gornall, Steven N. Kaplan & Ilya A. Strebulaev, *How Venture Capitalists Make Decisions: An Inside Look at an Opaque Process*, HARV. BUS. REV. (Mar.–Apr. 2021), https://hbr.org/2021/03/how-venture-capitalists-make-decisions [https://perma.cc/GW5N-CKUL].

43. *What is Venture Capital and How Does it Work?*, PITCHBOOK (Aug. 19, 2021), https://pitchbook.com/blog/what-is-venture-capital [https://perma.cc/M8K5-LJZN].

44. PITCHBOOK DATA, INC. & NAT'L VENTURE CAP. ASS'N, VENTURE MONITOR: Q4 2020, PITCHBOOK-NVCA (2020), https://www.svb.com/globalassets/trendsandinsights/reports/venture-monitor/vm-q4-2020/q4_2020_pitchbook_nvca_venture_monitor.pdf [https://perma.cc/L45R-GSKL]. *See also*, Kate Clark, *Inside Tiger Global's Deal Machine*, THE INFO. (Apr. 6, 2021, 6:00 AM), https://www.theinformation.com/articles/inside-tiger-globals-deal-machine?utm_medium=email&utm_campaign=article_email&utm_content=article-6290&utm_source=sg&rc=j8xyfa [https://perma.cc/BX9D-7EHH].

45. *What Is Venture Capital and How Does It Work?*, *supra* note 43.

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The traditional venture capital firm is typically formed as a limited partnership.[46] The limited partners may include foundations, insurance companies, universities, or wealthy individuals.[47] General partners make the decisions in the venture capital fund.[48] They decide how the money is invested; the limited partners simply contribute the funds.[49] The venture capital fund's managers are paid through management fees and carried interest which is the "share of any profits that the general partners of private equity and hedge funds receive as compensation."[50] Typically, 20% of the profits are allocated to the general partners, and the rest of the profits are distributed to the limited partners.[51] Venture capital investors actively manage their portfolio companies (companies the venture capital fund invests in) and frequently add non-pecuniary value to such companies "through the professionalization of startup teams, advising on time to product market, monitoring behavior, board involvement, improving company governance structures, and producing mutually beneficial relationships between portfolio companies and [venture capitalists'] networks."[52]

46. Akhilesh Ganti, *Venture Capitalist (VC) Definition*, INVESTOPEDIA (May 31, 2022), https://www.investopedia.com/terms/v/venturecapitalist.asp [https://perma.cc/HC25-3ME8].

47. *Id.*

48. *Id.*

49. *Id.*

50. James Chen, *Carried Interest*, INVESTOPEDIA (July 28, 2022), https://www.investopedia.com/terms/c/carriedinterest.asp [https://perma.cc/DTR2-CPGJ].

51. Ganti, *supra* note 46.

52. Michael Chow, *Venture Capital's Role in Innovation-Driven Entrepreneurship and Economic Growth*, NVCA BLOG (Aug. 12, 2021), https://nvca.org/venture-capitals-role-in-innovation-driven-entrepreneurship-and-economic-growth/ [https://perma.cc/RGN8-L4WH]. Venture capital firms have a stockpile of cash and some opined that limited partners continue to be "bullish on the asset class despite this year's rout of tech valuations and interest rate increases that typically divert investors away from venture capital." In fact, "dry powder—money raised but not deployed—has increased by more than $100 billion worldwide since the end of last year, reaching almost $539 billion in July [2022] . . . . [it is] in part the result of investors preparing for an extended bear market fueled by economic uncertainties including inflation and higher interest rates . . . ." Marc Vartabedian & Berber Jin, *Venture Capital's Cash Stockpile Swells Amid Slowdown*, WALL ST. J. (Aug. 10, 2022), https://www.wsj.com/articles/venture-capitals-cash-stockpile-swells-amid-slowdown-11660125600 [https://perma.cc/592X-LC7F].

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The term "venture capital fund"[53] is defined under Rule 203(l)-1 in the Investment Advisers Act of 1940 (the "Advisers Act").[54] Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended Section 203(l) of the Advisers Act in 2011 and directed the Securities and Exchange Commission ("SEC") to issue final rules regarding the definition of "venture capital fund" for purposes of the exemption and any reporting requirements.[55] Essentially, the amendment exempted investment advisers that solely advise venture capital funds from SEC registration requirements.[56] In order to meet the definition of a "venture capital fund," or "private fund,"[57] five criteria must be met. First, the fund must represent itself to investors and potential investors as pursuing a "venture capital strategy."[58] Second, the fund may invest no more than 20% of its assets in assets other than "qualifying investments"[59] and short-term-holdings,[60] which essentially means that non-equity holdings—such as debt instruments, publicly traded securities, or shares of venture capital funds acquired on the secondary market—would not constitute more than 20% of the fund's assets. Third, there are limitations on

53. A venture capital firm differs from a venture capital fund—they are separate legal entities. A venture capital firm is typically structured as a limited liability company. It then forms a venture capital fund (formed as a limited partnership), which is funded by investments from limited partners (typically pension funds, high net worth individuals, universities, family offices, etc.). ANDY SPARKS, RAISING VENTURE CAPITAL, (2021) https://www.holloway.com/g/venture-capital/sections/vc-firms-and-funds [https://perma.cc/D47L-5XMQ] (defining "venture capital firm" as "a collection of legal entities formed for the purpose of generating substantial returns for its investors by investing in high-risk companies that have yet to prove that their business models work and are sustainable in the marketplace," and "venture capital fund" as "a legal entity, created by—but separate from—a VC firm, that pools money from outside investors and directs investments to companies seeking capital. Venture capital funds are typically structured as partnerships").

54. Investment Advisers Act, 15 U.S.C. §§ 80b-1 to 80b-21 (1940).

55. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. 111-203 § 407, 124 Stat. 1376, 1574–75 (now codified at 15 U.S.C. § 80b-3(l)).

56. *Id.*

57. Defined in Section 202(a)(29) of the Advisers Act, as revised by the Dodd-Frank Act. It can be an investment company pursuant to Section 3 of the Investment Company Act of 1940 ("1940 Act"), subject to the exclusions detailed in Section 3(c)(1) or 3(c)(7) of the 1940 Act.

58. The definition of venture capital strategy depends on facts and circumstances.

59. 17 C.F.R. § 275.203(l)-1(c)(3).

60. Under Rule 203(l)-1(c)(6) it is defined as "cash and cash equivalents . . . U.S. Treasuries with a remaining maturity of 60 days or less, and shares of an open-end management investment company registered under Section 8 of the Investment Company Act of 1940 . . . that is regulated as a money market fund . . . ." 17 C.F.R. § 275.203(I)-1.

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leverage—no more than 15% of the fund's aggregate capital contributions and uncalled committed capital can be used for borrowing, issuing debt obligations, providing guarantees, or otherwise incurring leverage, and must have "a non-renewable term that is no longer than 120 calendar days."[61] Fourth, the securities issued must "not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata."[62] Fifth, the fund cannot have elected to be treated as a business-development company[63] and or be registered under Section 8 of the Investment Company Act of 1940.[64] As we will see in the discussion in Part II below, as traditional venture capital funds change their services and business models in response to the influx of new competitors—the nontraditional investors—they may no longer meet the legal requirement of venture capital funds.

Traditional venture capital firms tend to be small. Venture capital firms reported in a survey that they "had just 14 employees and five senior investment professionals" on average.[65] Venture capitalists are also known to be active advisers once they invest in a startup. "[T]hey 'interact substantially' with 60% of their portfolio companies at least once a week and with 28% multiple times a week."[66] They also offer a wide range of post-investment services.[67]

There is also a subset of traditional venture capital called micro-venture capital (the "micro-VC") funds that are either smaller venture firms that invest between $25,000 to $500,000 in seed-stage startups or are funds earmarked for such investment purposes

61. 17 C.F.R. § 275.203(l)-1(a)(3).

62. 17 C.F.R. § 275.203(l)-1(a)(4).

63. Defined in Section 2(48) of the Investment Company Act of 1940.

64. 17 C.F.R. § 275.203(l)-1(a)(5).

65. "This pocket-sized, flat structure allows for quick decision-making and action—but perhaps fewer checks and balances." Gompers et al., *How Venture Capitalists Make Decisions*, *supra* note 42.

66. *Id.*

67. These services include "strategic guidance (given to 87% of their portfolio companies), connections to other investors (72%), connections to customers (69%), operational guidance (65%), help hiring board members (58%), and help hiring employees (46%)." *Id.*

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within a larger fund.[68] These micro-VC funds are either less than $50 million or less than $100 million vehicles.[69] Initially, these types of funds were intended to fill in the funding gap (the "seed funding") prior to when the traditional venture capital firms typically came in during the Series A funding.[70] In 2010, 58% of funds closed were micro-VC funds; in 2020, it was 51%.[71] In 2020, they represented 6% of capital raised overall (in the decade before, they represented 14%).[72] In order to stand out, these funds must have a robust public relations campaign, have a strong online presence, and specialize in a particular area.[73] For example, the fund could specialize in a particular industry such as food allergies,[74] a certain geographical area,[75] or invest in underrepresented founder groups.[76]

Venture capital firms have become so ubiquitous that even celebrities are founding their own firms. Athletes such as Serena

68. Trent Dykes, *What Is Micro-Venture Capital?*, THE VENTURE ALLEY BY DLA PIPER (Sept. 5, 2014), https://www.theventurealley.com/2014/09/what-is-micro-venture-capital/ [https://perma.cc/5NLD-A2LV].

69. Rebecca Szkutak, *How Venture Capital's New Crop of Micro Funds Punch Above Their Weight*, FORBES (June 3, 2021, 10:09 AM), https://www.forbes.com/sites/rebeccaszkutak/2021/06/03/how-venture-capitals-new-crop-of-micro-funds-punch-above-their-weight/?sh=56aaf856865e. *See also* Dykes, *supra* note 68 (in 2014, the typical micro-VC fund size was less than $50 million and the funds were "managed by former venture capitalists, former entrepreneurs and/or super angels").

70. Szkutak, *How Venture Capital's New Crop of Micro Funds Punch*, *supra* note 69.

71. *Id.* at 3.

72. *Id.*

73. *Id.*

74. *Id.* at 5 (citing Allerfund, which raised $20 million to focus on investments in early-stage companies addressing food allergies).

75. Szkutak, *How Venture Capital's New Crop of Micro Funds Punch*, *supra* note 69, at 5. (noting TampaBay Ventures, which has a $20 million fund to invest in entrepreneurs in Tampa Bay, Florida).

76. *Id.* at 6 (citing Sixty8 Capital which focuses its investments on Black entrepreneurs) (Pitchbook analyst, Joshua Chao, noted, "[f]unds specific for female founders and people of color, . . . target these startups to get them on a level playing field and equalize a lot of the capital.").

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Williams[77] and Joe Montana,[78] and musicians like Snoop Dogg,[79] are jumping into the fray, given the lucrative nature of the market.

B. Corporate Venture Capital

Corporate venture capital ("corporate venture capital" or "CVC") is a subset of venture capital. Simply put, they are "equity investments in external startups made by corporations or investment entities designated by corporations."[80] In the past, they have been derisively called "dumb money"[81] because corporate venture capital was viewed as not valuation sensitive and adding little value.[82] Unlike venture capital firms, corporate venture capital does not solely focus on the financial returns; they consider the strategic benefits of their venture investments as well.[83] Corporate venture capital differs from other nontraditional investors. While the other nontraditional investors are relative newcomers to the startup scene, corporate venture capital began in the 1960s and has already experienced four waves of development.[84] Legally, they may be structured in different ways.[85]

77. Serena Williams founded Serena Ventures in 2014. SERENA\VENTURES, https://www.serenaventures.com/ [https://perma.cc/48GP-X6L9] (last visited Sept. 27, 2022).

78. Joe Montana, former quarterback for the San Francisco 49ers, started his own venture capital firm, Liquid2 Ventures. LIQUID2 VENTURES, https://liquid2.vc/ [https://perma.cc/8TTZ-WEDF] (last visited Sept. 27, 2021). One of his portfolio companies, GitLab, has gone public. Ari Levy, *Joe Montana Prepares for Biggest Windfall as a Venture Capitalist Ahead of GitLab's $10 billion IPO*, CNBC (Oct. 13, 2021, 4:27 PM), https://www.cnbc.com/2021/10/13/joe-montana-prepares-for-biggest-venture-win-as-gitlab-goes-ipo.html?recirc=taboolainternal [https://perma.cc/PTQ4-AF5T].

79. Snoop Dogg co-founded Casa Verde Capital which is focused on startups in the cannabis industry; it raised "$100 million for its second investment fund." Jonathan Shieber, *Snoop Dogg's Casa Verde Capital Closes on $100 Million as the Cannabis Industry Bounces Back*, TECHCRUNCH (Dec. 21, 2020, 4:04 PM), https://techcrunch.com/2020/12/21/snoop-doggs-casa-verde-capital-closes-on-100-million-as-the-cannabis-industry-bounces-back/ [https://perma.cc/SW6A-D8XB].

80. Fan, *Catching Disruption*, *supra* note 8, at 341. *See also* Henry W. Chesbrough, *Making Sense of Corporate Venture Capital*, HARV. BUS. REV. (Mar. 2002), https://hbr.org/2002/03/making-sense-of-corporate-venture-capital [https://perma.cc/N9H8-SJSX].

81. Mark Lennon, *Corporate Venture Investors Starting to Look a Lot More Like Private VCs*, TECHCRUNCH (Nov. 5, 2013), https://techcrunch.com/2013/11/05/corporate-venture-investors-starting-to- look-a-lot-more-like-private-vcs/ [perma.cc/WE5V-7HJ4].

82. Fan, *Catching Disruption*, *supra* note 8, at 380.

83. *Id.* at 343.

84. *Id.*

85. *Id.* at 364–68.

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In earlier waves, corporate venture capital "tended to invest only in the later stages of startups, and generally did not designate board members. Now the opposite is true: corporations increasingly make investments in the early-stages of startups through their CVCs, and CVCs frequently designate board members . . . ."[86] The ranks of corporate venture capital have increased exponentially since the financial crisis of 2008.[87] When there is corporate venture capital participation in a financing, the average deal size is double that of those that only include traditional venture capital firms.[88] Unlike venture capital funds, CVCs may not receive carried interest or fixed fees.[89] However, there are ways that corporations can structure their CVC arms to have a compensation structure similar to venture capital firms.[90] CVCs are also not bound to a timeline like venture capital firms. "In fact, taking CVC money may have the unintended effect of allowing private companies to stay private longer because CVCs are not pushed to exit by limited partners like venture capital and private equity funds are."[91]

Another interesting development is that venture capital-backed startups themselves have increasingly started to invest in other startups.[92] Consider that in 2015, some unicorns co-invested with

> In terms of the legal mechanics, CVCs are structured in a few different ways: (1) corporations join existing venture capital funds as limited partners; (2) current operating business units are tasked with venture capital investing; (3) wholly-owned subsidiaries are organized for the exclusive purpose of CVC; (4) dedicated funds are co-managed by a venture capital fund and the corporation; and (5) evergreen or discretionary funds make investments opportunistically and capital is allocated when such opportunities arise. CVC operations are structured in a variety of ways ranging from simple (resembling the general partner, limited partner structure of a venture capital fund) to complex. "The simplest way to structure a [CVC] operation is for the corporation to invest as a [venture capitalist] directly from the corporate treasury, with employees managing the investment activities." Due to financial issues (i.e., accounting, tax, and compensation) and internal corporate politics, however, corporations have had to implement creative structures or contractual arrangements.

Id. (footnotes omitted).

86. *Id.* at 345.

87. Fan, *Catching Disruption*, *supra* note 8, at 350.

88. *Id.* at 352.

89. *Id.* at 374.

90. *Id.*

91. *Id.* at 375.

92. *The Rise of Venture-Backed Startups Investing in Other Startups*, CB INSIGHTS (Sept. 3, 2015), https://www.cbinsights.com/research/startups-investing-in-startups/ [https://perma.cc/QL4Q-Z9AK].

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their own investors in startup financings, launched investment funds with their venture investors, or established their own corporate venture capital arm.[93] In fact, from 2013 to 2019, CVC funds of VC-backed private companies invested more than $2 billion in startups.[94] In 2021, Blockchain.com, Coinbase, and Twilio were among the more prolific investors.[95]

CVC investments, like other nontraditional investors, have experienced significant growth. Through the third quarter of 2021, they reached $100 billion in deal value participation.[96] Deal count has also risen exponentially over the last ten years: CVCs logged 600 deals in 2011, and as of the third quarter of 2021, there were already over 2,600 deals by CVCs.[97] At the end of 2021, CVC's participation in venture capital deals doubled its previous high and experienced a 50% growth in deal count.[98] "As startups are able to grow faster and challenge corporations sooner in their lifetime, emerging tech investments are a valuable way for corporates to iterate their products and develop new offerings while still

93. *Id.* (citing Flipkart and Didi-Kuaidi as participants in startup financings; TwilioFund, an investment fund launched by Twilio (then a startup), and its investors, Bessemer Venture Partners, DFJ, and Redpoint Ventures; and Expensify, which launched its own CVC, Expensify Ventures).

94. Megan Hernbroth, *Private Venture-Backed Startups Like Slack and Airbnb Are Investing in Other Startups. Here's Where Their Money Is Going*, BUS. INSIDER: INDIA (June 16, 2019, 5:30 PM), https://www.businessinsider.in/private-venture-backed-startups-like-slack-and-airbnb-are-investing-in-other-startups-heres-where-their-money-is-going-/articleshow/69813187.cms [https://perma.cc/G43V-AX9W] (noting that Slack was one of the earliest startups to invest in other startups in 2013; Airbnb, Stripe, and Coinbase (all private companies at the time) followed).

95. VENTURE MONITOR: Q4 2021, *supra* note 16, at 26. As the economy worsens and inflation rises, some CVCs are pulling back. Aidan Ryan, *Coinbase Pulls Back Its Startup Investing as Others Weigh Options*, THE INFO. (June 28, 2022), https://www.theinformation.com/articles/coinbase-pulls-back-its-startup-investing-as-others-weigh-options?utm_medium=email&utm_campaign=article_email&utm_content=article-8251&utm_source=sg&rc=j8xyfa [https://perma.cc/ZM6A-GHYU] (citing Coinbase as an example of a CVC that is slowing its startup investments). Even though CVCs are pulling back on their investments, it seems that they are in this asset class (venture capital) for the long haul. They also differentiate themselves from traditional venture capital firms in a downturn: "Corporates can bring revenue, distribution and product expertise, which leads to getting the product out to market and reduces risk. They're effectively forms of non-dilutive capital which you need in a downturn . . . ." Leah Hodgson, *Are Corporate VC 'Tourists' Pulling Back Amid the Downturn?*, PITCHBOOK (Aug. 4, 2022), https://pitchbook.com/news/articles/corporate-VC-pullback-downturn [https://perma.cc/WBG4-LN3P].

96. *2022 U.S. Venture Capital Outlook*, *supra* note 29, at 14.

97. *Id.*

98. VENTURE MONITOR: Q4 2021, *supra* note 16, at 26.

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leading in market share."[99] For some CVCs, like American Express Ventures, their investments in startups have become a major factor in their innovation strategy.[100] PitchBook predicted that more than 1,500 CVCs would make a startup investment in 2022.[101] One of the reasons behind this increase in CVC activity is that they can learn from and collaborate with startups "within their product ecosystem [which] is a valuable part of corporate growth that cannot be generated through organic research and development (R&D) programs."[102] More than a majority of CVC investments occur at the seed and early-stages, "requiring less capital but providing the opportunity for a high non-cash return. The liquidity timeline of early-stage deals also insulates these companies from short-term shifts in market sentiment."[103] CVC's parent companies have also had corporate profits for the past few years, and they will likely continue to invest to gain further insight into developing technologies. Although they may not invest at the same pace as in 2021 due to the current economic situation, the importance of being at the forefront of new technologies continues to offer a competitive advantage that they are unlikely to relinquish.[104]

It was not only the increased deal count that demonstrated the impact of CVCs on the startup landscape, but it was also the sheer amount of money that they brought. As an example, SoftBank, which falls under the category of corporate venture capital, was "the world's biggest tech investor" and disrupted the investing ecosystem as a result.[105] Its $100 billion Vision Fund "wrote eye-popping checks at record-high valuations starting around 2017, forc[ing] classic investors . . . to rethink their playbook."[106]

99. *2022 U.S. Venture Capital Outlook*, *supra* note 29.

100. Jessica Mathews, *How Fortune 500 Behemoth American Express Quietly Became a Venture Capital Powerhouse*, FORTUNE (Feb. 25, 2022, 12:15 PM), *https*://fortune.com/2022/02/25/american-express-venture-capital-investments-outlook/?utm_source=Iterable&utm_medium=email&utm_campaign=reader&tpcc=reader [https://perma.cc/BG9K-6JEF].

101. *2022 U.S. Venture Capital Outlook*, *supra* note 29, at 1.

102. VENTURE MONITOR: Q4 2021, *supra* note 16, at 26.

103. STANFORD, *supra* note 17, at 6.

104. *Id.* at 5.

105. *Hard Truths About SoftBank*, THE ECONOMIST (June 17, 2021), https://www.economist.com/business/2021/06/17/hard-truths-about-softbank [https://perma.cc/4SRK-XTYA].

106. Clark, *Softbank*, *supra* note 3, at 3. "Even after SoftBank hit a credibility crisis due to a series of failed investments that earned it a reputation for overcapitalizing, the firm's

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Such massive funding complicates venture firms' attempts "to generate profit for themselves. The VC firms typically have to return the initial capital to their LPs before their partners take their cut."[107] Also, the growth in the venture capital market meant that investors needed to deploy capital faster.[108] As a result, valuations rose and "investors [were] more willing to pay high prices for early-stage companies—prices historically reserved for much more mature businesses."[109] There was not much time for startups "to grow into their valuation. For investors and founders alike, this approach added more hazard to an already risky endeavor."[110] Although writing such large checks as SoftBank did was unprecedented at the time, it became the norm, with many nontraditional investors investing in startups frequently and in staggering amounts.[111]

C. Private Equity

Generally, private equity firms acquire a controlling equity interest in the companies they choose to invest in and are typically structured as a closed-ended investment fund with time-limited restrictions on transferability.[112] Investors in private equity are typically charged a 20% incentive fee and a 2% management fee.[113] Institutional investors and accredited investors are the investors in private equity.[114]

Venture capital and private equity both aim "to increase the value of the business they invest in and then sell their equity stake

impact in the VC arena is undeniable." *Id.* SoftBank's second Vision Fund was funded by parent company SoftBank Group (the first Vision Fund was funded primarily by Saudi Arabia and others). *Id.*

107. *Id.* at 4.

108. *Id.* at 5.

109. *Id.*

110. *Id.* at 5.

111. *See* discussion *infra* Part II.

112. *Private Equity Vs. Hedge Fund*, CFI, https://corporatefinanceinstitute.com/resources/careers/jobs/private-equity-vs-hedge-fund/ [https://perma.cc/6ZW5-UU77] (last visited Sept. 28, 2022).

113. *Id.* (noting that incentive fees are charged only when the hurdle rate is crossed, which means that if the hurdle rate is 10% and the annualized returns are lower than that then the investors are not charged the incentive fee).

114. James Chen, *Private Equity Explained with Examples and Ways to Invest*, INVESTOPEDIA, https://www.investopedia.com/terms/p/privateequity.asp [https://perma.cc/537J-PN7L] (last updated July 28, 2022).

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(aka ownership) for a profit."[115] Despite sharing the same goal, however, they historically have differed in four significant ways: which companies they invest in, the amount of capital they invest, how much equity they get, and when they invest in a startup's lifecycle.[116] Now, however, the differences are increasingly blurred. A few examples follow of how the playbook for private equity investing in startups has changed in the past few years.

Consider Insight Partners, which is a hybrid private equity and venture capital firm. It is one of the fastest-growing private investment firms.[117] As of September 2021, it had participated in over 150 venture capital investments—doubling its 2020 total.[118] It hired over 100 employees during the pandemic and its headcount is now at 300.[119] Detractors characterize Insight Partners' investment strategy as "spray and pray," but its fund performance illustrates its success in "building extra-large stakes in bootstrapped, or self-funded, companies based outside Silicon Valley, often in enterprise software."[120] Its army of associates and analysts identify 25,000 new potential investments on a yearly basis to [add to] the firm's database.[121] Although Insight Partners has typically invested in late-stage technology startups, it has begun investing in early-stage companies due to the heated competition in the late stage.[122] It also offers large checks to obtain more ownership than is customary, but that strategy does not always work with entrepreneurs who may want less dilution or who are concerned about accepting too much money before their product has an established market.[123] It is also more involved with its portfolio companies than Tiger (described below).[124]

115. *What Is Venture Capital and How Does It Work?*, *supra* note 43.

116. *Id.*

117. Clark, *SoftBank*, *supra* note 3, at 2.

118. Kate Clark, *Insight Partners, Venture Capital's 'Sleeping Giant,' Wakes Up*, THE INFO. (Sept. 17, 2021, 6:00 AM), https://www.theinformation.com/articles/insight-partners-venture-capitals-sleeping-giant-wakes-up?rc=j8xyfa [https://perma.cc/JR36-PCUN].

119. *Id.*

120. *Id.*

121. In order to motivate their junior investors, they are offered a small amount of equity for startups that they discovered—an uncommon practice in the industry. *Id.*

122. *Id.*

123. Clark, *Insight Partners*, *supra* note 118.

124. The two frequently partner together as they complement each other. Insight also teams with Coatue Management which, like Insight, works closely with its portfolio companies. *Id. See also,* Erin Woo, *Coatue, Under Pressure from Late-Stage Bets, Seeks $500 Million for*

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In 2021, private equity firms "participated in more than [fifty-seven percent] of . . . U.S. deal value, the highest of any nontraditional investor type[;]" they completed 850 mega deals and an additional 185 in the first quarter of 2022.[125] During an economic downturn, growth equity private equity funds will try to lower valuations of startups. "The lower valuations will bring the opportunity to take a larger stake and a potential increase in future returns should the exit environment swing back to the strength seen in recent years."[126]

D. Mutual Funds

A mutual fund is defined as an open-end investment company or open-end fund that "pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt."[127] These funds "are registered with the SEC and subject to SEC regulation. In addition, the investment portfolios of mutual funds typically are managed by separate entities known as

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Early-Stage Deals, THE INFO. (Oct. 13, 2022, 6:00 AM), https://www.theinformation.com/articles/coatue-under-pressure-from-late-stage-bets-seeks-500-million-for-early-stage-deals?utm_content=article-8888&utm_source=sg&utm_medium=email&utm_campaign=article_email [https://perma.cc/HD2H-CWNV] (demonstrating Coatue's attempt to raise its third fund to invest in early-stage startups after valuations of its mature startups plummeted in 2022).

125. STANFORD, *supra* note 17, at 6.

126. *Id.* Some of the most active nontraditional investors have decreased their activity in the venture capital space compared to a year ago. Jessica Mathews, *The Most Active VC Investors in Q2 2021 Are Pumping the Brakes*, FORTUNE (July 5, 2022, 5:37 AM), https://fortune.com/2022/07/05/vc-investors-q2-2021-q2-2022-venture-funding/?utm_source=email&utm_medium=newsletter&utm_campaign=term-sheet&utm_content=2022081113pm&tpcc=nltermsheet [https://perma.cc/44CA-R9CE] (comparing Q2 2021 to Q2 2022 investments).

127. *Mutual Funds*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1 [https://perma.cc/BE83-BYM5] (last visited Sept. 28, 2022). A portfolio is the combined holdings of the mutual fund and is managed by an SEC-registered investment adviser. *Mutual Funds and ETFs: A Guide for Investors*, U.S. SEC. & EXCH. COMM'N 4 (2019), https://www.investor.gov/sites/investorgov/files/2019-02/mutual-funds-ETFs.pdf [https://perma.cc/G9CT-QB8G] (last visited Sept. 28, 2022). Investors typically purchase shares (or redeem such shares) in mutual funds from the fund itself or through a broker for the fund. *Mutual Funds*, INVESTOR.GOV, *supra* note 127. The price per share is the "value of the mutual fund's assets minus its liabilities—[it's] . . . called the NAV or net asset value. Mutual funds must sell and redeem their shares at the NAV that is calculated after the investors places a purchase or redemption order." *Mutual Funds and ETFs*, *supra* note 127, at 4.

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investment advisers that are also registered with the SEC."[128] There are different types of mutual funds; some are actively managed, and others are not.[129] Each fund is subject to different fees and expenses, different risks, and different volatility.[130]

Mutual funds have traditionally not invested much in startups but recently have started to aggressively invest in these companies and, more specifically, in unicorns. In 2017, there were over $10 billion in such investor assets across 250 funds; in 2021, that amount had ballooned.[131] "While tech companies have traditionally raised money from venture capitalists, mutual funds have plowed money into late-stage startups, seeking the kinds of returns they previously would have achieved from companies going public earlier in their life cycles."[132] As an example, in July 2020, T. Rowe Price Associates led a $2.5 billion investment round in Rivian, an electric-vehicle startup and competitor to Tesla.[133] Shares of Rivian were priced at $78 when it went public on November 9, 2021, and surged to $106.75 per share on November 10, 2021.[134]

Professor Jeff Schwartz offered a compelling analysis of the regulatory implications of these types of investments in the mutual-fund context and outlined several concerns: lack of investor awareness about these investments, liquidity issues (specifically, the inability to redeem mutual fund shares), and lack of competence and candor in valuation methods for private company shares.[135] Using Fidelity Magellan Fund as a case study, Professor

128. *Introduction to Investing Glossary: Mutual Funds*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/glossary/mutual-funds [https://perma.cc/BZB5-FG7E] (last visited Sept. 28, 2022).

129. *Id.*

130. *Mutual Funds and ETFs*, *supra* note 127, at 15.

131. Schwartz, *supra* note 40. *See also Startup Stock Tracker*, WALL ST. J. (Mar. 3, 2016, 4:00 PM), http://graphics.wsj.com/tech-startup-stocks-to-watch/ [https://perma.cc/K22B-K27S].

132. Biz Carson, *A 'Tourist Investor,' Not a VC Firm, Has the Most Investments in Billion-Dollar Tech Startups*, BUS. INSIDER (Sept. 20, 2016, 10:44 AM), https://www.businessinsider.com/fidelity-wins-billion-dollar-tech-startups-2016-9 [https://perma.cc/U9UM-MKRF].

133. Michael Wayland & Lora Kolodny, *T. Rowe Price Leads $2.5 Billion Investment Round into EV Startup Rivian*, CNBC (July 10, 2020, 10:59 AM), https://www.cnbc.com/2020/07/10/t-rowe-price-leads-2point5-billion-investment-round-into-rivian.html [https://perma.cc/4YF5-SSRJ].

134. Lora Kolodny & Annie Palmer, *EV Start-up Rivian Is Valued at $86 Billion After Market Debut, Higher than Ford*, CNBC (Nov. 10, 2021, 9:19 AM), https://www.cnbc.com/2021/11/10/amazon-backed-ev-start-up-rivian-set-to-go-public-.html [https://perma.cc/G3KP-ASQ3].

135. Schwartz, *supra* note 40, at 1341. *See also* Qi Chen, Itay Goldstein & Wei Jiang, *Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows*, 97 J. FIN.

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Schwartz found that although liquidity does not seem to be a concern, "there is reason to suspect that investors fail to realize . . . mutual funds are investing in unicorns[,] mutual fund investments in these securities are inadequately informed, and that the valuations that mutual funds report publicly and serve as the basis of redemptions and purchases may be inflated."[136]

He suggested ways to limit the discretion over valuations and also proposed mandating prominent disclosure of venture capital investments and their accompanying risks.[137] However, until such measures are adopted, the manner in which mutual funds continue to operate when investing in private companies leaves investors ill-informed and private companies potentially having inflated valuations, all of which contribute to the breakdown of the public-private divide.

E. Hedge Funds

Hedge funds—"actively managed alternative investments that commonly use risky investment strategies"[138]—are legally structured as a private investment limited partnership that a limited number of accredited investors can invest in; they require a sizeable initial minimum investment.[139] They are managed by money managers who are compensated with a "performance fee" of 20% of the profits and a fee of 1–2% of the assets of the hedge fund.[140] In valuing illiquid holdings, such as securities in private

ECON. 239, 240 (2010); Yao Zeng, *A Dynamic Theory of Mutual Fund Runs and Liquidity Management* 1 (Eur. Systemic Risk Bd., Working Paper No. 42, Apr. 2017), http://hdl.handle.net/10419/193549 [https://perma.cc/83CN-W3CD]; Sergey Chernenko, Josh Lerner & Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns* (Eur. Corp. Governance Inst., Working Paper No. 675, 2020), https://ssrn.com/ abstract=2897254.

136. Schwartz, *supra* note 40, at 1346.

137. *Id.* at 1347.

138. *What Is a Hedge Fund? Examples, Types, and Strategies*, INVESTOPEDIA (Aug. 11, 2022), https://www.investopedia.com/terms/h/hedgefund.asp [https://perma.cc/Z6UU-U8V7].

139. *Id.*

140. *Id.* Note that the fee is based on net asset value ("NAV") which means that if the NAV was $100 at the time of investment and then rose to $110 then the hedge fund would get an incentive on the $10 difference; if the NAV was below $100, the hedge fund would not get any incentive. *Private Equity Vs. Hedge Fund*, *supra* note 112. There is a debate between Marty Lipton and Lucian Bebchuk on the consequences of hedge fund activism. Lipton asserts that management myopia results from hedge funds' focus on short-term results. Martin Lipton, *Empiricism and Experience; Activism and Short-Termism; The Real World of Business*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 28, 2013),

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companies (which are difficult to value), hedge funds are not subject to any standard methodology in calculating performance.[141] Opportunities to redeem or cash in shares in hedge funds are usually limited, and there is often a lock-up period of a year or more when an investor cannot redeem shares.[142]

Typically, hedge fund investors have focused on the public markets, but with the record high value of U.S. startup acquisitions and public listings reaching $290 billion in 2020, and numerous companies going public at over $1 billion valuations, there is an increased incentive to invest earlier.[143] "In the first half of 2021, hedge funds participated in 128 U.S. startup deals, surpassing the 118 deals the firms made during all of [2020] and topping the 109 made in 2019, according to PitchBook."[144] In fact, the most active venture investor on a global scale was Tiger.[145] It raised $12.8 billion for its latest fund: Private Investment Partners 15.[146]

https://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/ [https://perma.cc/4ZXQ-ZNXQ]. Bebchuk, on the other hand, argues that their engagement decreases agency costs. Lucian Bebchuk, *The Myth of Hedge Funds as 'Myopic Activists'*, WALL ST. J. (Aug. 6, 2013), https://www.wsj.com/articles/SB10001424127887323309404578614004210782388; *see also* Lucian Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015).

141. *Investor Bulletin: Hedge Funds*, SEC OFF. OF INV. EDUC. & ADVOC., https://www.sec.gov/files/ib_hedgefunds.pdf [https://perma.cc/2CL6-BDHA] (last visited Sept. 28, 2022).

142. *Id.* at 2 (noting that hedge funds may charge redemption fees and suspend redemptions under certain conditions).

143. Clark, *Inside Tiger Global's Deal Machine*, *supra* note 44; "Silicon Valley Bank's chief business development officer Sunita Patel said . . . that some hedge funds were adjusting their strategies to aim further down the private market food chain as valuations soar in pre-IPO deals, the stage at which they typically invest." Vartabedian, *Asset Managers Help*, *supra* note 15.

144. Vartabedian, *Asset Managers Help*, *supra* note 15, at 1.

145. *Id.* (noting that Tiger Global Management had eighty-one venture capital deals in the second quarter of 2021; Andreessen Horowitz came in second with 21% fewer deals than Tiger). It continued to be the most active investor in Q1 2022. CB INSIGHTS, STATE OF VENTURE GLOBAL | Q1 2022 Slides 8, 14 (2022), https://www.cbinsights.com/reports/CB-Insights_Venture-Report-Q1-2022.pdf? [https://perma.cc/N8DA-PEG9].

146. Eliot Brown & Juliet Chung, *Highflying Tiger Global Humbled by Unraveling of Giant Tech Bet*, WALL ST. J. (June 6, 2022, 11:12 AM), https://www.wsj.com/articles/tiger-global-giant-tech-bet-11654523735 [https://perma.cc/PJ62-AT9U]:

> Tiger, led by 46-year-old founder Charles "Chase" Coleman, stood out in the frenzy. **Its venture-capital business in March raised a $12.7 billion fund, one of the industry's largest ever**. Tiger overall invested in 361 deals in 2021, up from 16 deals for all of 2017, more than any other U.S. manager . . . . It often outflanked longstanding venture firms by moving faster and agreeing to more generous terms with startups . . . . (emphasis added).

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"Compared with VC firms, hedge funds typically place less emphasis on the ownership on the capitalization table . . . . They often don't require a board seat, while VC firms typically do, which may be an attractive dynamic for some independent-minded founders."[147] Hedge funds also generally focus on "generating shorter-term liquidity as opposed to traditional venture investors who are more patient in growing the company over time . . . ."[148]

According to a recent report from the Goldman Sachs sales and trading desk titled "Hedge Funds and the Convergence of Private and Public Equity Investments[,]" hedge fund participation in venture capital deals has grown "enormously."[149] From January 2021 to June 2021, hedge funds participated in a record-breaking number of private deals—770 in all—with an aggregate value of $153 billion.[150] In contrast, on average, from 2000–2010, hedge fund managers participated in over 50 deals per year.[151] Funding startups is no longer exclusive to venture capitalists, and with relative newcomers like hedge funds taking smaller returns on longer time periods, VC deals have become much more competitive.[152]

Hedge funds have done deals at a rapid pace in recent years. As an example, Tiger, a 100-person New York firm, averaged over four deals a week "much to the astonishment and chagrin of rival VC firms."[153] It has also raised huge funds—in April 2021, it raised a

See also Kate Clark & Berber Jin, *Tiger Global Raised $11 Billion for New Venture Fund, Exceeding Target*, THE INFO. (Feb. 3, 2022, 4:02 PM), https://www.theinformation.com/articles/tiger-global-raised-11-billion-for-new-venture-fund [https://perma.cc/7B37-BNGN]; STANFORD, *supra* note 17, at 4.

147. Vartabedian, *Asset Managers Help*, *supra* note 15.

148. *Id.*

149. Sam Shead, *Goldman Sachs Says Hedge Funds Are Increasingly Trying to Compete with VCs in Private Deals*, CNBC (Sept. 10, 2021, 3:56 AM), https://www.cnbc.com/2021/09/10/goldman-sachs-says-hedge-funds-are-competing-more-with-vcs.html?tpcc=nltermsheet [https://perma.cc/3M6Z-S652].

150. Joshua Franklin & Laurence Fletcher, *Hedge Funds Muscle in to Silicon Valley with Private Deals*, FIN. TIMES (Sept. 8, 2021) https://www.ft.com/content/4935b205-8344-465a-8edf-dc23ec990302?tpcc=nltermsheet [https://perma.cc/VUB4-9EMA] (75% of the capital deployed to private companies originated from ten hedge funds). Shead, *supra* note 149.

151. Shead, *supra* note 149 (noting that 2007 was an outlier with 117 deals).

152. "The vast majority, 72%, of private hedge fund deals, are in the venture capital space, Goldman said, adding that 44% can be classed as later stage and growth equity deals." *Id.*

153. "Tiger leveraged its heft—as both a venture capitalist and a manager of funds trading stocks like Zoom, Uber and Amazon—to make faster bets on startups." Clark, *Inside Tiger Global's Deal Machine*, *supra* note 44.

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$6.7 billion fund.[154] In total, it has $65 billion in assets under management, which is much more than venture capital firms based in Silicon Valley.[155] In October 2021, it raised $8.8 billion for what is expected to be a $10 billion fund.[156] The largest investors in the firm are its own employees.[157] Tiger's private equity business has generated impressive returns—"a 33% gross fund internal rate of return and a 26% net IRR."[158] Notably, a majority of the firm's assets are comprised of the private equity business.[159]

Tiger does not take the hands-on approach that traditional venture capital firms are famous for; instead, it outsources, paying consultants at Bain & Co. to provide advice to its portfolio companies on various matters, such as product launches.[160] Tiger also does not take board seats.[161] Its investment approach is more aggressive than traditional venture capital investors or other nontraditional investors; it often approaches startups even before such startups decide to raise money.[162] Tiger was also known for its

154. Tiger Glob. Private Inv. Partners XIV, L.P., Notice of Exempt Offering of Securities (Form D) (Mar. 31, 2021), https://www.sec.gov/Archives/edgar/data/1854273/000185427321000001/xslFormDX01/primary_doc.xml [https://perma.cc/2CRZ-7EL6].

155. Clark, *Inside Tiger Global's Deal Machine*, *supra* note 44.

156. Hema Parmar, *Tiger Global Raises $8.8 Billion in First Close of Biggest Fund*, BLOOMBERG (Oct. 25, 2021, 10:43 AM), https://www.bloomberg.com/news/articles/2021-10-25/tiger-global-raises-8-8-billion-in-first-close-of-biggest-fund?sref=YqYS2qcg [https://perma.cc/624C-K2NK].

157. Other investors include endowments, foundations, pensions, and sovereign wealth funds (defined below in Section I.F). "[I]ts own employees . . . are collectively believed to be the firm's biggest investors at this point." Connie Loizos, *Tiger Global Just Closed One of the Biggest Venture Funds Ever, with $6.7 Billion*, TECHCRUNCH (Apr. 1, 2021, 12:48 PM), https://techcrunch.com/2021/04/01/tiger-global-just-closed-one-of-the-biggest-venture-funds-ever-with-6-7-billion/ [https://perma.cc/7WGG-QYF7].

158. Stephen Taub, *How Chase Coleman Became a Hedge Fund Legend*, INST. INV. (Mar. 10, 2021), https://www.institutionalinvestor.com/article/b1qx3m96ts35s3/How-Chase-Coleman-Became-a-Hedge-Fund-Legend [https://perma.cc/TZ3X-W9KC].

159. *Id.*

160. Clark, *Inside Tiger Global's Deal Machine*, *supra* note 44.

161. Jamie Powell, *Tiger Global: Pay and Spray*, FIN. TIMES (Jan. 31, 2022), https://www.ft.com/content/1dcdda5a-9274-4519-9a5f-c460b8e1b251 [https://perma.cc/35C8-VYAJ].

162. In the case of FalconX, a cryptocurrency exchange, Tiger sent the founder extensive notes documenting Tiger's customer interviews when expressing its interest in investing in the startup. *Id.* Tiger ultimately led a $50 million round at a $675 million valuation. Gillian Tan, *Tiger Invests in Crypto Platform FalconX Valued at $675 Million*, BLOOMBERG (Mar. 11, 2021, 5:45 AM), https://www.bloomberg.com/news/articles/2021-03-11/tiger-invests-in-crypto-platform-falconx-valued-at-675-million [https://perma.cc/22XD-KWVV].

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quick turnaround in deals—taking a mere three days from first conversations to a term sheet.[163] It purchased both new shares from the company it invested in and made secondary-share purchases (buying shares from existing shareholders), which has not been customary for traditional venture capital firms.[164] However, with the economic downturn, Tiger, along with some of its peers, "slash[ed] their offers for shares of private software startups, sometimes after founders signed the investment paperwork . . . ."[165] Consider that Tiger lowered its valuation for a Series C deal with Veriff, an identity verification startup, from $1.5 billion to $1.1 billion, before ultimately returning to its original valuation after Veriff solicited offers from other investors.[166] It also renegotiated deal terms with Blockdaemon, a blockchain startup, before wiring money, dropping the valuation by 20% (but still more than double the startup's valuation from its prior funding round which took place a few months prior).[167] Recently, Tiger announced that due to its high exposure in illiquid venture capital bets, it would reduce its management fees to 1% through December 2023.[168] In addition, it would charge a 10% performance fee on gains instead of the typical 20% until it makes up more than 100% of lost investor cash.[169] Lastly, Tiger will allow clients to cash out and redeem 33% of their shares (typically, it is limited to 20–25%) in the hedge fund, even if a lockup is in place.[170]

163. Clark, *Inside Tiger Global's Deal Machine*, *supra* note 44.

164. *Id.*

165. Berber Jin & Kate Clark, *Tiger Global, Alkeon Slash Startup Valuations Amid Public Stock Selloff*, THE INFO. (Jan. 26, 2022, 6:28 PM), https://www.theinformation.com/articles/tiger-global-alkeon-slash-startup-valuations-amid-public-stock-selloff?rc=j8xyfa [https://perma.cc/P9MG-4VHX].

166. *Id.*

167. *Id.*

168. Hema Parmar, *Tiger Global's 52% Plunge Prompts Fee Cut, Redemption Plan*, BLOOMBERG (June 2, 2022, 4:08 AM), https://www.bloomberg.com/news/articles/2022-06-02/tiger-global-losses-for-the-year-reach-52-after-drop-in-may [https://perma.cc/K73G-VML5].

169. *Id.*

170. *Id.*

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F. Sovereign Wealth Funds

Sovereign wealth funds ("sovereign wealth funds" or "SWFs") have a range of definitions.[171] "Generally, SWFs are considered to be government-owned investment funds, set up for a variety of macroeconomic purposes and which are typically funded by foreign exchange assets that invest long term overseas."[172] Some may even be funded by states and cities instead of countries.[173] These funds are intended to either "stabilize government finances through short-term swings in natural resource price cycles . . . or . . . to deliver multigenerational economic stimulus as a government transitions past nonrenewable resource income or invests excess capital[] in the form of development funds or savings funds."[174] There are five types of sovereign wealth funds: stabilization funds, savings funds, development funds, pension reserve funds, and reserve investment funds.[175] Stabilization funds hold a higher portion of liquid investments because they are more reactionary.[176] "Savings funds, which make up the bulk of funds and [assets under management], are designed to provide an

171. *Sovereign Wealth Funds—A Work Agenda*, INT'L MONETARY FUND 26 (Feb. 29, 2008), https://www.imf.org/external/np/pp/eng/2008/022908.pdf [https://perma.cc/5YH8-FC5M].

172. "They are quite distinct from government-owned pension funds which have well-defined liabilities and from state-owned enterprises whose primary function is production or the provision of services." *Id.* The International Monetary Fund's proposed definition is as follows: "SWFs are special purpose public investment funds . . . owned or controlled by the government, and hold, manage, or administer assets primarily for medium- to long-term macroeconomic and financial objectives.*" *Id.* SWFs frequently arise "out of official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports[]" and "employ a set of investment strategies which include investments in foreign financial assets." *Id.* "*These, in principle, include: (i) fiscal stabilization funds; (ii) saving funds; (iii) reserve investment corporations; (iv) development funds; and (v) pension reserve funds (those without explicit pension liabilities), while it excludes inter alia: (a) government-employee pension funds; (b) social security funds; (c) government lending funds; and (d) government-owned banks." *Id.*

173. WYLIE FERNYHOUGH, PITCHBOOK, 3Q 2019 ANALYST NOTE: SOVEREIGN WEALTH FUND OVERVIEW 2 (Aug. 8, 2019), https://pitchbook.com/news/reports/3q-2019-pitchbook-analyst-note-sovereign-wealth-fund-overview [https://perma.cc/A7P2-XBAC]. For example, Alaska has a sovereign wealth fund, the Alaska Permanent Fund Corporation. *Id.* at 9.

174. *Id.* at 1.

175. Abdullah Al-Hassan, Michael Papaioannou, Martin Skancke & Cheng Chih Sung, *Sovereign Wealth Funds: Aspects of Governance Structures and Investment Management* 5 (Int'l Monetary Fund, Working Paper WP/13/231, 2013), https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Sovereign-Wealth-Funds-Aspects-of-Governance-Structures-and-Investment-Management-41046 [https://perma.cc/7TE5-BSLS].

176. FERNYHOUGH, *supra* note 173, at 2.

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economic boost to the local economy."[177] With a multigenerational time horizon, savings funds are "the SWFs of most interest to private market practitioners."[178] It is the most relevant for purposes of investments in startups as over 70% of their portfolio shares are allocated to equities and other investments that are high-risk returns.[179] For example, the Abu Dhabi Investment Authority and Norway Government Pension Fund Global are focused on growing assets rather than distributions.[180] In fact, sovereign wealth funds are now major participants in private capital funds and increasingly acting as general partners "by directly sourcing deals and teaming up with other [general partners] on investments."[181] Specifically, savings funds are "well suited for higher levels of illiquid assets and investments with equity ownership . . . ."[182] The third type of sovereign wealth funds, development funds, not only invest for multigenerational gains but also promote economic growth within their countries.[183] Sovereign wealth funds may have multiple objectives and, therefore, may have both development funds and savings funds. Singapore is an example of having both types of funds in the forms of GIC and Temasek.[184] There are also pension reserve funds which are organized "to meet identified outflows in the future with respect to pension-related contingent-type liabilities on the government's balance sheet . . . ."[185] Lastly, there are reserve investment funds. This form of sovereign wealth fund places "high allocations in equities and alternative

177. *Id.*

178. *Id.* at 3.

179. Al-Hassan et al., *supra* note 175, at 5.

180. FERNYHOUGH, *supra* note 173, at 3. The Norway Government Pension Fund Global has over $1 trillion in assets and is the largest natural resource sovereign wealth fund. *Id.* at 4. It is still accumulating funds for this particular fund and are focused "on replacing oil's economic impact once reserves run dry." *Id.* at 4.

181. *Id.* at 1.

182. *Id.* at 3.

183. *Id.*

184. Al-Hassan et al., *supra* note 175, at 3. "Many funds in resource-rich economies have multiple objectives, such as stabilization/savings (Azerbaijan, Botswana, Trinidad & Tobago, and Norway), saving/pension reserve (Australia), or stabilization/saving/development (Kazakhstan)." *Id.* at 6.

185. *Id.* at 5–6. The Russian National Wealth Fund falls into this category and its investments are not disclosed. *Russian National Wealth Fund*, BLOOMBERG, https://www.bloomberg.com/profile/company/2900282Z:RU [https://perma.cc/HT99-VCNS] (last visited Sept. 27, 2022).

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investments," creating the potential for ample returns while assets remain as reserves.[186]

Sovereign wealth funds are not new—in some countries, such as Kuwait and Singapore, they have existed for several decades.[187] Due to "high oil prices, financial globalization, and sustained, large global imbalances[, there has been] rapid accumulation of foreign assets[,] particularly by oil exporters and several Asian countries."[188] Accordingly, there has been a rapid rise in the number and size of sovereign wealth funds, and such funds have become increasingly prominent in the international capital markets.[189] "From the viewpoint of international financial markets, SWFs can facilitate a more efficient allocation of revenues from commodity surpluses across countries and enhance market liquidity, including at times of global financial stress."[190] They have over $8 trillion in assets under management.[191] Capital is allocated through in-house investment teams and there may be deals in the private markets as well.[192]

Sovereign wealth funds can have different legal structures, which may impact institutional arrangements and governance.[193] Botswana and Norway have sovereign wealth funds, which are structured as a pool of assets that are administered by the government or central bank but not legally separate from it.[194] Others have "separate legal entities under law with legal identities and full capacity to act[,]" such as Australia, Kuwait, New Zealand, and UAE (ADIA).[195] Others are "state-owned corporations . . . with

186. Al-Hassan et al., *supra* note 175, at 6 (noting that this sovereign investment fund structure is seen in China, South Korea, and Singapore). Reserve investment funds may also be referred to as reserve investment corporations. *See generally id.*

187. *Sovereign Wealth Funds – A Work Agenda*, *supra* note 171, at 4.

188. *Id.*

189. *Id.*

190. *Id.*

191. FERNYHOUGH, *supra* note 173, at 2.

192. *Id.*

193. *Sovereign Wealth Funds – A Work Agenda*, *supra* note 171, at 24 n.27.

194. *Id.* Other examples include Chile and Timor-Leste. Al-Hassan et al., *supra* note 175, at 9.

195. Al-Hassan et al., *supra* note 175, at 9.

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distinct legal persona;"[196] Singapore's Temasek is an example of this type of legal structure.[197]

There are tax and immunity of investments implications for each of the legal forms.[198] "Investments through central banks will normally be protected by sovereign immunity and may also enjoy tax privileges in recipient countries. Taxation of investments through corporate structures may depend on the extent to which these investments are viewed as an integrated part of the government's financial management."[199]

There are also institutional setups for sovereign wealth funds, which generally fall into one of two forms: the "manager model" and the "investment company model."[200] In the former, "the legal owner of the pool of assets constituting the SWF (usually the ministry of finance) gives an investment mandate to an asset manager."[201] In the latter, "the government as owner sets up an investment company that in turn owns the assets of the fund."[202]

Organizational structures of sovereign wealth funds are also important, and one must distinguish between governing and supervisory bodies. "The governing bodies constitute a system of delegated asset management responsibilities."[203] The governing body will then establish a supervisory body to help supervise the governing body that is below it in the hierarchy.[204]

Lastly, an appropriate investment mandate must be set by the owner of the sovereign wealth fund that includes the sovereign wealth fund's objective and risk-bearing capacity. "Both determinants will have a bearing on the investment universe and the proportion of the SWF exposed to 'risky' assets."[205]

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.* Bilateral tax agreements may also impact taxation of SWFs. *Id.*

200. Al-Hassan et al., *supra* note 175, at 10.

201. *Id.*

202. *Id.* "This model is typically employed when the investment strategy implies more concentrated investments and active ownership in individual companies (Temasek, Singapore), or the fund has a development objective in addition to a financial return objective." *Id.*

203. *Id.* at 11.

204. *Id.* "The role of the supervisory body is to verify that the supervised unit is acting in accordance with the regulations set by the governing body immediately above it in the governance structure." *Id.*

205. Al-Hassan et al., *supra* note 175, at 15.

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Sovereign wealth funds differ from the other nontraditional investors in significant ways. There are higher standards of accountability for sovereign wealth funds' investment decisions because of government ownership.[206] Strategies may also be "driven by noncommercial motives."[207] In contrast, hedge funds and private equity firms are subject to the control of their owners since they are privately owned.[208] Hedge funds are generally highly leveraged, unlike sovereign wealth funds.[209]

As venture deals and funds grew, so did sovereign wealth funds' investment in venture capital. They have invested in large venture capital funds, been the sole limited partner in a fund (sometimes for the purpose of getting in on early-stage deals), or directly invested in companies.[210] They even serve as lead investors at times, such as when Singapore's GIC was the lead investor for Chainalysis, a crypto fraud detection and tracking startup.[211]

The median deal size with sovereign wealth fund participation was more than twice that of any other nontraditional investor group in 2021—$100 million.[212] Although they participated in 8.2%

206. *Sovereign Wealth Funds—A Work Agenda*, *supra* note 171. *But cf.* Russian Direct Investment Fund ("RDIF"). "While officially a sovereign wealth fund, RDIF is widely considered a slush fund for President Vladimir Putin and is emblematic of Russia's broader kleptocracy." *Treasury Prohibits Transactions with Central Bank of Russia and Imposes Sanctions on Key Sources of Russia's Wealth*, U.S. DEPT. TREAS. (Feb. 28, 2022), https://home.treasury.gov/news/press-releases/jy0612 [https://perma.cc/2VTP-KU8X]. Executive Order 14024 authorized sanctions against Russia for its attack on Ukraine; these sanctions included blocking RDIF, its management company, and one of the managing company's subsidiaries from accessing the U.S. financial system. *Id.*

207. *Sovereign Wealth Funds—A Work Agenda*, *supra* note 171, at 27.

208. *Id.*

209. *Id.*

210. Rebecca Szkutak, *Why Are Sovereign Wealth Funds in Love with Venture?*, PRIV. EQUITY INT'L (July 7, 2020), https://www.privateequityinternational.com/why-are-sovereign-wealth-funds-in-love-with-venture/ [https://perma.cc/4T8D-QSBY].

211. Kate Clark, *Chainalysis Valued at $8.6 Billion in GIC-Led Investment*, THE INFO. (May 10, 2022, 4:42 PM), https://www.theinformation.com/articles/chainalysis-valued-at-8-6-billion-in-gic-led-investment?shared=1c0ef0604abc8145&rc=j8xyfa [https://perma.cc/8FY8-SSVZ].

212. STANFORD, *supra* note 17, at 7. Sovereign wealth funds' participation in venture capital investments is also another reason for the rise of the mega-deals and sharp increase in the amount invested in early-stage deals. "Early-stage, seed-round investments, which were typically US$500,000 can now be up to US$5m. With so much money to invest, there is a sharp drop in the number of deals in which multiple funds participate and less of a need for start-ups to go public." Robyn Klinger-Vidra & Juergen Braunstein, *How Sovereign Wealth Funds Are Inflating the Silicon Valley Bubble,* THE CONVERSATION (Aug. 21, 2016, 6:35 AM),

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of deal value in 2021, their participation decreased to 4.2% of deal value in the first quarter of 2021.[213]

G. Solo Venture Capitalists

A wave of venture capital investors at well-established venture capital firms such as Andreessen Horowitz, Redpoint Ventures, and Shasta Ventures have gone solo.[214] Some have opined that these solo venture capitalists are a "harbinger of venture capital's future."[215] There are also former startup employees who are raising their own funds. For example, Lachy Groom, a former Stripe product manager, has already raised three funds that focus on investing in seed and Series A deals. His third fund, LGF3, is a $250 million venture fund.[216] "The new fund, one of the largest raised by a solo venture capitalist, represents the growing influence of such individual investors in private financings."[217] Another example is Elad Gil, who raised $620 million from twenty-six limited partners.[218]

Some characteristics that define solo venture capitalists include the following: they are the only general partner of their fund, they are the sole member of the investment team, the brand of the individual is equivalent to the brand of the fund, they typically

https://theconversation.com/how-sovereign-wealth-funds-are-inflating-the-silicon-valley-bubble-101859 [https://perma.cc/DJ46-4UA5].

213. STANFORD, *supra* note 17, at 8.

214. Kate Clark, *Venture Capital's New Guard Goes Solo*, THE INFO. (Aug. 28, 2020, 7:01 AM), https://www.theinformation.com/articles/venture-capitals-new-guard-goes-solo?rc=j8xyfa [https://perma.cc/XJW2-D9AW] (profiling Li Jin, formerly of Andreessen Horowitz, and Nikhil Basu Trevedi, formerly of Shasta Ventures, among others).

215. Berber Jin, *The Rise of Elad Gil, Silicon Valley's Biggest Solo Venture Capitalist*, THE INFO. (Aug. 30, 2021, 6:01 PM), https://www.theinformation.com/articles/the-rise-of-elad-gil-silicon-valleys-biggest-solo-venture-capitalist?utm_source=google&utm_medium=cpc&utm_campaign=11543929116_112520154917&utm_content=477036477316&utm_term=dsa-453373912446&gclid=EAIaIQobChMIk8iQ7rqO9AIVGiitBh0bBgA5EAAYASAAEgJIHfD_BwE&rc=j8xyfa [https://perma.cc/YH2C-Q3JG] (noting Elad Gil's investments in particular).

216. LGF3, L.P., Notice of Exempt Offering of Securities (Form D) (June 25, 2021), https://sec.report/Document/0001868817-21-000001/primary_doc.html [https://perma.cc/FF8E-294T]. His second fund—in the amount of $110 million—launched last year. Jin, *Solo VC Lachy Groom*, *supra* note 12.

217. Jin, *Solo VC Lachy Groom*, *supra* note 12.

218. Jin, *The Rise of Elad Gil*, *supra* note 215; Cosmic - Aleph 1, L.P., Notice of Exempt Offering of Securities (Form D) (Mar. 27, 2020), https://www.sec.gov/Archives/edgar/data/1807070/000180707020000002/xslFormDX01/primary_doc.xml [https://perma.cc/UXW7-WWM8] (previously, Gil raised $300 million for his first fund which he launched in 2020).

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raise bigger funds and invest more than super angels, and they compete against traditional venture capital firms to lead seed, Series A, and later stage rounds.[219] Limited partners, such as university endowments and pension funds, are putting their money in solo venture capitalists, "betting that some founders will prefer to take money from well-connected individuals rather than the traditional VC firms that once dominated fundraising."[220] These solo venture capitalists differentiate themselves from traditional venture capital firms by taking a smaller equity stake, moving more quickly, and offering better deal terms.[221] "Founders are more often than not picking an individual partner who they want to work [with] in a financing round, based on the relationship built with them, and based on their brand and expertise, instead of the firm's."[222] Furthermore, solo venture capitalists are generally more flexible on deal terms such as ownership and board seats; they are "more creative in terms as a result of being sole decision-makers."[223] They may also generate higher multiple returns on their funds because their fund sizes will not increase dramatically.[224] Some experts contend that solo venture capitalists are motivated by carry.[225]

Solo venture capitalists also invest in startups at all stages. "According to PitchBook data, solo capitalists' 25 largest deals to date in 2021 were spread across Series A through E . . . ."[226]

They are even leading funding rounds. In 2021, "solo VC Elad Gil led a $300 million funding round in defense tech startup Anduril, a rare instance in which an individual, rather than a VC

219. Trivedi, *supra* note 12 (citing Josh Buckley, Shana Fisher, Elad Gil, Lachy Groom, Ray Tonsing, and Oren Zeev as ones that fit the definition of solo venture capitalist).

220. Jin, *The Rise of Elad Gil*, *supra* note 215 (citing Harvard University's endowment as one of Gil's limited partners).

221. *Id.*

222. Trivedi, *supra* note 12.

223. *Id.*

224. *Id.*

225. Abe Othman & Matthew Speiser, *Solo Capitalists Are Gaining on Traditional Venture Firms*, ANGELLIST VENTURE (Nov. 16, 2021), https://www.angellist.com/blog/solo-capitalists-vs-vc-firms [https://perma.cc/TH93-SPTJ] (noting that, in contrast, traditional venture capital firms "are being incentivized by management fees and therefore [assets under management]").

226. Freelen, *supra* note 2.

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firm, led a late-stage investment."[227] Generally, solo venture capitalists can move more quickly and are more flexible on deal terms than traditional venture capital firms, which enables them to win over founders.[228] They also co-lead deals with traditional venture capital firms. Consider that in March 2021, Groom co-led a $22 million Series A round with Sequoia Capital for Blues Wireless, "a leading provider of embedded cellular solutions."[229] Solo venture capitalists are also helpful to founders regarding key business decisions and have extensive networks that founders can access.[230]

In order to invest even more in promising startups, some solo venture capitalists, like Gil, use a special purpose vehicle ("SPV")—"a subsidiary company that is formed to undertake a specific business purpose or activity" and can be nearly any legal entity.[231] In the startup context, they are typically formed as limited liability companies—or limited partnerships—and function as "a fund through which individual investors are pooled to make one large, single investment in a startup."[232] The SPV works as follows: investors purchase membership units of the limited liability company and the limited liability company makes investments

227. Jin, *Solo VC Lachy Groom*, *supra* note 12. Gil also co-led TripActions' Series E round by putting in $40 million; the startup was valued at $5 billion. Jin, *The Rise of Elad Gil*, *supra* note 215.

228. Michael Grinich, a founder of WorkOS, a software startup, chose Groom's investment offer (which came before Benchmark's) over Benchmark's because Benchmark wanted 20% of the startup's shares whereas Groom would take only 15%. Jin, *Benchmark's VC Model Strained*, *supra* note 5.

229. *Blues Wireless Announces $22 Million Series A Funding to Meet Demand for Cellular Wireless Solutions*, CISION PR NEWSWIRE (July 12, 2021, 9:00 AM), https://www.prnewswire.com/news-releases/blues-wireless-announces-22-million-series-a-funding-to-meet-demand-for-cellular-wireless-solutions-301331040.html [https://perma.cc/7ZNA-TM55].

230. Jin, *The Rise of Elad Gil*, *supra* note 215 (citing examples of how Gil made himself available to founders to discuss ideas and big decisions and noting his expansive network which can lead to introductions to other investors).

231. Adam Hayes, *What Is a Special Purpose Vehicle (SPV) and Why Companies Form Them*, INVESTOPEDIA, https://www.investopedia.com/terms/s/spv.asp (last visited Sept. 24, 2022) (noting that special purpose vehicles have their own balance sheets since they are separate from the parent company and its investors).

232. Bill Clark, *Special Purpose Vehicles: Things to Know*, MICROVENTURES (Oct. 18, 2019), https://microventures.com/special-purpose-vehicles-things-to-know [https://perma.cc/MH2X-F26G]. *See, e.g.*, Alma Pekmezovic & Gordon Walker, *The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital*, 7 WM. & MARY BUS. L. REV. 347 (2016); THOMSON REUTERS, FEDERAL TAX COORDINATOR ¶ O-4213 to O-4214 (2d ed. Aug. 2022 Update).

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using the pooled investor funds.[233] An SPV differs from a traditional venture capital fund because an SPV can only make an investment in one company, whereas the latter can make investments across a number of companies.[234]

* * *

In order to visualize the similarities and differences between traditional venture capital firms and nontraditional investors, I offer a taxonomy here in chart form.

Table 1: Chart of Traditional Venture Capital Firms and Nontraditional Investors

Category [235]	**Stage of Investment (seed, early, late)**	**Board Seat (yes, no, some-times)**	**Additional Services to Help Portfolio Companies**	**Source of Money**	**Payment Structure**	**Legal Structure**
Tradition-al VC	Depending on the investment thesis of the VC, could be stage-specific or stage agnostic. Typically, VCs focus on a stage, sector, and	Yes, if lead investor	Yes, connections to customers/ partners, potential next-round investors and employee/ management prospects	Limited partners, such as pension funds, university endowm-ents, and wealthy individuals	20% carry, 1–2% in manage-ment fees	Venture funds are typically limited partnerships with an LLC general partner. However, with more closely held venture funds (where you have a single limited partner), the venture fund might be an LLC. General partner is

233. Because SPVs hold assets that are deemed to be securities by the SEC, they are captured under the definition of "investment company." *See* Investment Company Act of 1940, 15 U.S.C. § 80a-3(a) (2018). They must register with the SEC and comply with the 1940 Act's requirements unless they fall under an exclusion. *See* 15 U.S.C. § 80a-3(c). In this case, SPVs would be excluded from registration because they are selling their securities in private placements pursuant to Section 3(c)(1) of the Investment Company Act of 1940.

234. An SPV can help simplify the capitalization table because only the LLC is listed (as opposed to the individual investors); on the flip side, however, the investors in an SPV do not have any individual rights in the company—all decisions are made by the owner of the SPV. Bill Clark, *Special Purpose Vehicles*, *supra* note 232. In other instances, SPVs may be used for pro rata allocations when a fund does not have sufficient capital left to invest or the companies are outside of the fund's typical investment profile. *What Is an SPV?*, ANGELLIST, https://learn.angellist.com/deal-terms/spv [https://perma.cc/5CZQ-GB9P] (last visited Sept. 24, 2022).

235. Hedge funds and mutual funds are sometimes referred to as crossover investors. In this Article, the two categories are addressed separately because of their different legal structures and different approaches to investing.

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Category [235]	**Stage of Investment (seed, early, late)**	**Board Seat (yes, no, some-times)**	**Additional Services to Help Portfolio Companies**	**Source of Money**	**Payment Structure**	**Legal Structure**
	often geography.					venture capital firm.
Corporate VC	Typically late stage, but increasingly investing in earlier stages	Not the typical approach, but sometimes if lead investor	Sometimes; also provides network connections. May also become material customer/ commercial partner.	Company itself, including the corporate level of the parent company, one of the parent company's business units, or external investment partners, such as a venture capital fund.	CVCs may not receive carried interest or fixed fees. Some corporat-ions may structure their CVC funds as independ-ent or semi-independ-ent funds to remain competiti-ve, which may include carried interest.	Different structures include: (1) corporations join existing venture capital funds as limited partners; (2) current operating business units are tasked with venture capital investing; (3) wholly-owned subsidiaries are organized for the exclusive purpose of CVC; (4) dedicated funds are co-managed by a venture capital fund and the corporation; and (5) evergreen or discretionary funds make investments opportunistically and capital is allocated when such opportunities arise.
Private Equity	Late stage, but increasingly investing in earlier stage if such startup has revenue	Sometimes, if lead investor	No, but provides network connections. Similar to traditional venture capital firms, but they also often bring their own back-off and host of resources to support their portfolio companies. PEs take a	Same as traditional venture capital	20% incentive fee only after hurdle rate is crossed, 2% managem ent fee	Typically closed-ended investment funds with time-limited transferability restrictions.

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Category [235]	**Stage of Investment (seed, early, late)**	**Board Seat (yes, no, some-times)**	**Additional Services to Help Portfolio Companies**	**Source of Money**	**Payment Structure**	**Legal Structure**
			much more involved approach in management because they typically control more than half of the portfolio company.			
Mutual Fund	Late stage	No	No	Collects and pools money from multiple investors, including retail investors	Fees are fund depend-ent.	Open-end investment company, registered with the SEC, investment portfolios often managed by registered investment advisors.
Hedge Fund	Seed, early, and late-stage	No	No, outsources help but provides network connections	Primarily its own employees	Fee is based on the net asset value.	Typically open-ended investment funds with no restrictions on transferability; private investment limited partnership that a limited number of accredited investors can invest in.
Sovereign Wealth Fund	Late stage	No	No, but there are tax privileges and immunity of investment implications	States, cities, or countries and may include foreign exchange assets	N/A	Different structures include: (1) pool of assets administered by the government or central bank, but not legally separate from it; (2) separate legal entity; or (3) state-owned corporation. Set-up as either manager model (with investment mandate) or

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Category[235]	**Stage of Investment (seed, early, late)**	**Board Seat (yes, no, some-times)**	**Additional Services to Help Portfolio Companies**	**Source of Money**	**Payment Structure**	**Legal Structure**
						investment company model (government sets up investment company that owns assets of fund). Four types of funds: (1) stabilization funds, (2) savings funds, (3) development funds, and (4) pension reserve funds; savings funds are most commonly used for investments in startups.
Solo Venture Capitalist	Typically seed or early, but increasingly at later stages, too	Sometimes	Yes; they also have extensive network connections, smaller equity stakes, move more quickly, offer better deal terms, and are helpful to founders on key business decisions since they often come from operator backgrounds.	Limited partners (e.g., university endowments and pension funds), former startup employees, high-net-worth individuals, or well-connected industry experts	Typically 20% carry, 1–2% in management fees	Sometimes structured as a limited partnership or limited liability company with a single investing partner making investments in a portfolio of companies, sometimes structured as a one-off special purpose vehicle for each investment or direct investment as an individual.

II. THE IMPACT OF NONTRADITIONAL INVESTORS ON THE LEGAL & BUSINESS ASPECTS OF VENTURE CAPITAL DEALS

This Part sets out how nontraditional investors have impacted startups and, specifically, their fundraising efforts. Further, the discussion illustrates how the diversification of investors has created a more complex investment system, which may cause

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friction and lead to thorny issues in the future, especially during an economic downturn. In addition, this Part illustrates how nontraditional investors have facilitated the rise and proliferation of unicorns, which has contributed to the breakdown of the public-private divide, with the attendant problems of investor protection, corporate governance challenges, valuation bubbles, and the like.

A. How Traditional Investors Make Deals

Before delving into how nontraditional investors impact the terms of venture capital financings and startup corporate governance, this Part will first look at how traditional venture capital firms make investment decisions as a point of comparison. Specifically, what factors are important in deciding whether a startup should be one of the firm's portfolio companies? A plurality of the venture capitalists surveyed in a study done by business scholars cited deal selection as the most essential element to the creation of value in their portfolios; deal sourcing and post-investment actions were also key.[236] When structuring the terms in a venture capital financing, venture capitalists stated that "they were relatively inflexible on pro rata investment rights, liquidation preferences, and antidilution rights (which protect their potential economic upside) as well as on the vesting of the founders' equity, the company's valuation, and board control (which is often seen as the most important control mechanism)."[237] From a legal perspective, these terms, as well as the others set out in a term sheet that memorializes the understanding between the startup and investors regarding economics and control, are set out in five documents: the Certificate of Incorporation,[238] the Stock Purchase Agreement,[239] the Investors' Rights Agreement,[240] the Right of First

236. Gompers et al., *How Venture Capitalists Make Decisions*, *supra* note 42.

237. *Id.*

238. *Model Legal Documents*, NVCA, https://nvca.org/model-legal-documents/ [https://perma.cc/7DMW-AMK9] (last visited Sept. 24, 2022) (choose "Certificate Of Incorporation (Updated September 2020)"); Certificate of Incorporation [https://perma.cc/UW9W-HFQH].

239. *Model Legal Documents*, *supra* note 238 (choose "Stock Purchase Agreement (Updated September 2020)"); Stock Purchase Agreement [https://perma.cc/95B3-Q8A5].

240. *Model Legal Documents*, *supra* note 238 (choose "Investors' Rights Agreement (Updated August 2021)") [https://perma.cc/7DMW-AMK9]; Investors' Rights Agreement [https://perma.cc/T8FH-558C].

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Refusal and Co-Sale Agreement,[241] and the Voting Agreement.[242] The more negotiable terms in the survey were cited as the dividends, investment amount, option pool (amount of equity to allocate for employees), participation rights (after the investor receives its full liquidation preference, it has the right to participate with the common stockholders in the distribution of the remainder of the proceeds from a sale or exit event), and redemption rights (gives stockholders the right to force the company to repurchase shares).[243] However, beyond the financial terms, it was equally important to venture capitalists that the startup was a fit with their other portfolio companies and that the venture capitalists' experience and expertise would be helpful to the founding management team.[244] Venture capitalists expect to get minority ownership in a company in exchange for the capital they provide.

B. How Nontraditional Investors Negotiate Deals

Imagine, however, what happens if the nontraditional investors are more flexible on the very terms that traditional venture capital firms are not. For example, if a nontraditional investor offered the same valuation as a venture capital firm but did not insist on a board seat (even if it leads the round), it is likely that the startup may choose the nontraditional investor for the deal.[245] In these types of scenarios, where nontraditional investors are willing to give up certain terms that are considered "must haves" for an investor to participate, traditional venture capital firms will likely lose out on deals. The terms of venture capital deals became increasingly founder-friendly in the post-Great Recession

241. *Model Legal Documents*, *supra* note 238 (choose "Right of First Refusal and Co-Sale Agreement (Updated September 2020)") [https://perma.cc/7DMW-AMK9]; Right of First Refusal and Co-Sale Agreement [https://perma.cc/8UL4-C32W].

242. *Model Legal Documents*, *supra* note 238 (choose "Voting Agreement (Updated March 2022)") [https://perma.cc/7DMW-AMK9]; Voting Agreement [https://perma.cc/7YEA-RJ4Y].

243. Gompers et al., *How Venture Capitalists Make Decisions*, *supra* note 42.

244. *Id.*

245. It is less likely that nontraditional investors would give up on liquidation preferences and antidilution rights, although they may take a watered-down version of liquidation preference, such as a non-participating liquidation preference at one times the original purchase price. *See, e.g.*, Vartabedian, *Asset Managers*, *supra* note 15; *see also, e.g.*, discussion *infra* Section I.D (discussing how hedge funds typically do not take board seats which may make them more attractive to founders who want to maintain control of the board).

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economy.[246] This created an environment in which founders had more leverage and were able to dictate the terms of the deal; in a situation where the economy is not doing well, it is the investors who regain power and are able to negotiate deal terms more favorable to them.[247]

Consider the case of Benchmark Capital ("Benchmark"), one of the most storied venture capital firms famous for its investments in Dropbox, eBay, Instagram, Twitter, Uber, Yelp, and Zillow, among others.[248] Investors in Benchmark's eight funds in 2015 were paid out $22.6 billion—a 1,000% gain (net of fees) over a ten-year period.[249] Benchmark represents an older model of venture capital financing. Founded in 1995, each of its first four partners had an equal venture partnership irrespective of the outcome of their individual investments; this distinguished it from other firms that based profit sharing on the success of individual investments.[250] Benchmark also has higher management fees and takes a higher percentage of profit (also known as "carry") than other venture capital firms.[251]

246. Investors lose bargaining power during a robust economy. "This shift is even quantifiable: The PitchBook VC Dealmaking Indicator has shown a marked trend toward founder-friendly dynamics since mid-2020." Thorne, *supra* note 14. "Founders have raised larger and larger rounds as [PitchBook's] VC dealmaking indicator points to a period of unprecedented founder friendliness." VENTURE MONITOR: Q4 2021, *supra* note 16, at 9. In addition, the participation of nontraditional investors allowed startups to stay private longer. *See, e.g.*, Sungjoung Kwon, Michell Lowry & Yiming Qian, *Mutual Fund Investments in Private Firms*, J. FIN. ECONS. 1, 22 (May 11, 2019) (noting that "mutual fund financing significantly increases the probability that a firm stays private longer."); Fan, *The Landscape of Startup Corporate Governance*, *supra* note 34.

247. Q2 2022 PitchBook-NVCA Venture Monitor First Look, PITCHBOOK (July 7, 2022), https://files.pitchbook.com/website/files/pdf/Q2_2022_PitchBook-NVCA_Venture_Monitor_First_Look.pdf. [https://perma.cc/U2T2-VCUR].

248. *See, e.g.*, Alex Konrad, *The Benchmark Way: Five Partners Who Make Other VC Firms Look Outgunned and Overstaffed*, FORBES (Mar. 25, 2015, 9:30 AM), https://www.forbes.com/sites/alexkonrad/2015/03/25/benchmark-makes-other-firms-look-outmatched/?sh=29c0df4e4006 [https://perma.cc/SH9Y-43XZ] (Benchmark invested $32 million in Twitter which was worth $2.2 billion in 2015); *From Alibaba to Zynga: 45 of the Best VC Bets of All Time and What We Can Learn from Them*, CB INSIGHTS (June 9, 2021), https://www.cbinsights.com/research/best-venture-capital-investments/ [https://perma.cc/R3FD-B8SY].

249. Konrad, *The Benchmark Way*, *supra* note 248.

250. Jin, *Benchmark's VC Model Strained*, *supra* note 5.

251. Benchmark's management fees are 2.5%, and they take 30% of profits—all of which are divided equally among the partners. Konrad, *The Benchmark Way*, *supra* note 248.

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Benchmark's early bets on eBay, Snap, Twitter, Uber, and Zillow illustrated the strengths of its model.[252] However, when Benchmark tried to replicate this model globally, it failed, so it ended the experiment in 2010.[253] Benchmark then had a very public spat with Uber CEO, Travis Kalanick, and successfully ousted him, which gave it unwanted attention.[254] Generally speaking, Benchmark prefers to own at least 20% of a startup at an early-stage and be the sole lead investor in a financing round.[255] "It focuses almost exclusively on a company's first or second institutional rounds of funding and likes to take the biggest stake of any outside investor plus a board seat, so it can influence the direction of its portfolio companies."[256] According to Benchmark veteran Bill Gurley, referrals or repeat founders comprise 60% of its deals.[257]

Consensus for deals was a Benchmark hallmark before the pandemic.[258] However, this has had consequences. Benchmark's investment expectations and slower decision-making process has become more difficult to hold onto with the increasingly crowded field of investors.[259] Furthermore, Benchmark has typically not had new limited partners invest in its funds; this is in stark contrast to its competitors who have done so.[260] Benchmark has also not

252. Jin, *Benchmark's VC Model Strained*, *supra* note 5.

253. *Id.*

254. *See, e.g.*, Kara Swisher, *The Uber Civil War Is Now a PR Battle*, VOX (Aug. 18, 2017, 7:03 AM), https://www.vox.com/2017/8/18/16166082/uber-travis-kalanick-benchmark-bill-gurley-pr-war-court-filings [https://perma.cc/J2SM-XZQ4]; David Pierson & Tracey Lien, *Early Uber Investor Sues Co-Founder Travis Kalanick, Accusing Him of Fraud*, L.A. TIMES (Aug. 10, 2017, 4:25 PM), https://www.latimes.com/business/la-fi-tn-uber-lawsuit-20170810-story.html [https://perma.cc/F2XE-SJDG].

255. Jin, *Benchmark's VC Model Strained*, *supra* note 5.

256. Konrad, *The Benchmark Way*, *supra* note 248. Unlike other traditional venture capital firms, it does not demand pro rata investment rights in future rounds of financing. "It doesn't do so-called insider rounds, when an investor re-ups with a startup at a higher valuation, and it tries to find opportunities for 'preemptive strikes,' leading a financing round with a company that hasn't started to raise money." *Id.*

257. *Id.*

258. "[T]he Benchmark partner championing the company would split up a piece of paper so that each partner could write down a number from one to [ten], reflecting their enthusiasm. Partners rarely moved forward with an investment if any jotted down a number lower than five . . . ." Jin, *Benchmark's VC Model Strained*, *supra* note 5; *Cf.* "Andreessen Horowitz, which allows individual partners to act more unilaterally." *Id.*

259. *Id.*

260. *Id.*

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increased its headcount—there are no scout programs or associates that identify potential new partners.[261]

Benchmark's reluctance to change its terms may come at the cost of participating in the venture capital financings of hot startups. For example, Michael Grinich, the founder of WorkOS, a software startup, was approached by Benchmark about its interest in investing in his startup.[262] However, Lachy Groom had already offered to buy 15% of WorkOS's shares; Benchmark did not match his offer and wanted at least 20%.[263] Grinich chose Groom over Benchmark.[264]

Benchmark's experience is indicative of what could happen if a traditional venture capital firm decides not to agree to more favorable terms similar to the ones that a nontraditional investor may agree to. In the past few years, nontraditional investors have been increasingly winning over startups with these more favorable terms.

C. Deal Timelines and Due Diligence

In the startup investment scene, competition is fierce between traditional venture capital firms and nontraditional investors in good economic times. As a result, there is more pressure to win deals and to get them done as quickly as possible.[265] Nontraditional investors, such as hedge funds, typically offered higher valuations and made decisions more rapidly than traditional venture capital

261. Instead, Benchmark has selected new partners based on their interactions when serving on the same corporate boards. *Id.*

262. *Id.*

263. Jin, *Benchmark's VC Model Strained*, *supra* note 5.

264. *Id.*

265. "Increasingly, venture capitalists are facing more intense pressure to not only win deals but ink them as quickly as possible." Kate Clark, *The Dark Side of the Funding Boom: Skimpy Due Diligence, Burnout*, THE INFO. (Aug. 12, 2021, 6:00 AM), https://www.theinformation.com/articles/the-dark-side-of-the-funding-boom-skimpy-due-diligence-burnout?utm_source=google&utm_medium=cpc&utm_campaign=11543929116_112520154917&utm_content=477036477316&utm_term=dsa-403373944996&gclid=EAIaIQobChMIodvG7cqT9AIVeyCtBh0iEQzNEAMYAyAAEgKmYvD_BwE&rc=j8xyfa [https://perma.cc/3G6H-C6YK]. Storied venture capitalist, Vinod Khosla, offers the following perspective: "If you're pursuing radical innovation, market cycles matter much less . . . . We should be cautious about frenzied valuations and investment cycles, but, aside from that, should ignore the ups and downs." Vinod Khosla, *Vinod Khosla: "Stop Asking Me About the Markets"*, THE INFO. (Jan. 31, 2022, 9:00 AM), https://www.theinformation.com/articles/vinod-khosla-stop-asking-me-about-the-markets [https://perma.cc/XKP8-WXYB].

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firms; this accelerated the deal timeline.[266] Solo venture capitalists also made deals more quickly since the founders only interacted with one general partner; the fact that the solo venture capitalist also has founder experience and more flexibility on deal terms makes them an attractive investor as well.[267]

Typically, it takes 83 days to close a venture capital deal.[268] During that time, venture capital firms spend 118 hours on due diligence and make calls to ten references on average.[269] However, nontraditional investors, like hedge funds, have closed in a few days.[270] As an example, Tiger's fast dealmaking accelerated the timeline for investments and forced competitors to move quicker and, sometimes, pay more in order to get the deal.[271] In the first three months of 2021 alone, Tiger funded 60 companies all over the world.[272] Faster timelines likely circumvented the due diligence process, however, and may have caused investors to use shortcuts to their detriment.[273]

The frenzied competition among traditional venture capital firms and nontraditional investors to participate in venture capital financings for the most sought-after startups also led to less due diligence. Investors have noted that "with so many new investors flocking to start-ups, due diligence is sometimes so minimal that it is used as a punchline . . . ."[274] A veteran entrepreneur, investor, and author observed, "An overheated market 'definitely creates an environment for people to make more inflated claims' and may

266. *Id.*

267. Trivedi, *supra* note 12.

268. Gompers et al., *How Venture Capitalists Make Decisions*, *supra* note 42.

269. *Id.*

270. Clark, *Venture Capital's 'Sleeping Giant'*, *supra* note 118.

271. Clark, *SoftBank*, *supra* note 3.

272. Clark, *Inside Tiger Global's Deal Machine*, *supra* note 44.

273. "As founders gain more power, investors may feel pressure to skimp on due diligence or general supervision of portfolio companies . . . . [F]ounders have increasingly pushed for ever-shorter deal timelines and want to cut back on so-called representations and warranties, a series of founder disclosures that give investors a clearer picture of what they're betting on." Thorne, *supra* note 14.

274. Erin Griffith, *What Red Flags? Elizabeth Holmes Trial Exposes Investors' Carelessness*, N.Y. TIMES (Nov. 4, 2021), https://www.nytimes.com/2021/11/04/technology/theranos-elizabeth-holmes-investors-diligence.html [https://perma.cc/2M65-6MDJ]; *see, e.g.*, VCs Congratulating Themselves (@VCBrags), TWITTER (Sept. 19, 2021, 5:46 PM), https://twitter.com/VCBrags/status/1439752810078392323 (showing a video making fun of how cursory due diligence is in the startup world).

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even tempt them to lie."[275] The increased deal flow also meant that the typical summer slowdown,[276] which allowed a respite, did not happen in 2020 and 2021.[277] It led to "burnout and mental exhaustion in the VC community."[278]

Normally, venture capitalists, alongside lawyers and accountants, do a careful review of the startup's business and leaders.[279] "One casualty of the rush to do deals quickly, say investors and lawyers, is due diligence, a once sacred part of the investing process."[280]

One of the significant ramifications of a hypercompetitive venture capital deal market is that in order to be the first investor with a term sheet, less due diligence is conducted.[281] It became "increasingly common to skip background checks for startup CEOs, several lawyers said."[282]

Additionally, legal opinions, which are typically done by the lawyers representing the startup and opine on matters related to the company's capitalization, corporate governance, and other matters, also became less common.[283] According to one partner in the venture capital deals space, "Investors today are only requiring legal opinions for about half of venture deals, compared to about

275. Griffith, *What Red Flags?*, *supra* note 274. A stark example of this is the due diligence (or lack thereof) in Theranos, where there is a tension between whether the investors could have done a better job of getting information or whether it would not have mattered because Elizabeth Holmes was giving inaccurate information. *Id.*

276. Mathews, *The Most Active VC Investors*, *supra* note 126.

277. "In normal times, investors can at least look forward to a summer slowdown, during which many of them traditionally step back from deals and take vacations. But for the second year in a row, many venture capitalists said work didn't let up in the summer." Clark, *The Dark Side*, *supra* note 265.

278. One person in the industry observed, "I've been in conversation with peers [who] are in tears . . . because they are losing and they feel like losers themselves." *Id.*

279. "It's a core part of the investment process that helps protect venture capitalists from investing in bad actors, as well as providing a better understanding of the companies' strengths and weaknesses." *Id.*

280. *Id.*

281. "[I]nvestors are cutting corners on diligence in order to be the first firm to offer a term sheet, a dangerous gamble that could diminish returns down the line." *Id.* "Deals are getting bigger and moving faster as heightened competition winnows away time for due diligence." Thorne, *supra* note 14.

282. Clark, *The Dark Side*, *supra* note 265.

283. Legal opinions gave comfort to investors that the appropriate corporate governance mechanisms were in place, such as the necessary approvals for the deals and the verification of the accuracy of the capitalization table. *Id. See, e.g.*, *Model Legal Documents*, *supra* note 238, (choose "Model Legal Opinion") [https://perma.cc/7DMW-AMK9].

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three-quarters three years ago . . . . VC and startup lawyers simply don't have enough time to conduct the diligence necessary to issue a legal opinion for every deal they work on."[284]

In addition to venture capital financings, law firms representing startups were also busy helping founders incorporate companies and negotiate term sheets.[285] Law firms either turned away work as a result or took on more work at the expense of junior attorneys who already carried a heavy workload.[286] It is unclear whether law firms that were inexperienced with venture capital financings participated in deals as a result.[287]

D. Increased Competition, Less Time Between Fundraising Rounds, and Conflicts of Interest

As difficult as it is to get funding, once a startup attracts the attention of various investors and receives multiple offers, the power dynamic changes.[288] Vinod Khosla, founder of Khosla Ventures and co-founder of Sun Microsystems, stated, "The best start-ups with inspiring entrepreneurs have intense competition to fund them . . . ."[289] Ninety-five percent of venture capital firms stated that founders were the most important factor in determining whether to do a deal.[290] The fifth most-cited factor in deciding whether to pursue a deal was the company's valuation.[291] Venture

284. Clark, *The Dark Side*, *supra* note 265. These opinions take a few weeks to complete and costs thousands of dollars in legal fees. *Id.*

285. *Id.*

286. *Id.* Cynically, there are those who think the latter is more common. "'A large firm will never not take on a client and the associate will just have to work 100 extra hours,' said Aravinda Seshadri, founding partner of Venturous Counsel, which offers legal advice to startups and funds led by underrepresented minorities." *Id.*

287. This is a very niche area of law practice. Just as there are repeat investors and repeat founders, there is a small circle of law firms which are well-known for deals representing startups and are also repeat counsel. The top ten highest ranked firms in the emerging companies and venture capital space include: Cooley, Wilson Sonsini Goodrich & Rosati, Gunderson Dettmer, Fenwick & West, Goodwin Procter, Latham & Watkins, Kirkland & Ellis, Orrick Herrington & Sutcliffe, Morrison & Foerster, and Davis Polk & Wardwell. *2023 Best Law Firms for Emerging Companies & Venture Capital*, FIRSTHAND, https://firsthand.co/best-companies-to-work-for/law/best-law-firms-in-each-practice-area/emerging-companies-and-venture-capital [https://perma.cc/ZX3Q-3A67] (last visited Oct. 5, 2022).

288. Gompers et al., *How Venture Capitalists Make Decisions*, *supra* note 42.

289. *Id.*

290. "The business model was cited as an important factor by 74% of firms, the market by 68%, and the industry by 31%." *Id.*

291. *Id.*

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capitalists disregard traditional financial evaluations because the real driver of their returns is their most successful mergers and acquisitions and initial public offering exits. "Although most investments yield very little, a successful exit can generate a 100-fold return. Because exits vary so much, VCs focus on finding companies that have the potential for big exits rather than on estimating near-term cash flows."[292] Term sheets are designed to reward the entrepreneur financially if the startup does well but give investors the power to take control if the startup fails to deliver.[293]

> Prior studies of VC investment terms show that VCs accomplish that through the careful allocation of cash flow rights (the financial upside that gives founders incentives to perform), control rights (the board and voting rights that allow VCs to intervene if needed), liquidation rights (the distribution of the payoff if the company flounders and has to be sold), and employment terms, particularly vesting (which gives entrepreneurs incentives both to perform and to stay at the company).[294]

However, if one lever of control is missing, such as the board seat, this carefully calibrated exercise of allocating control and economics will not work.

Now that nontraditional investors are in the mix, some of these terms, such as board seats, are no longer customary. This impacts how deals are structured and the influence that investors wield. Coupled with the fact that many nontraditional investors take a hands-off approach and are now investing even earlier in the lifecycle of the startup, the allocation of control and economics has changed.

Some studies indicate that a fundraising round should raise enough money for 18 to 24 months.[295] However, before the

292. *Id.*

293. Gompers et al., *How Venture Capitalists Make Decisions*, *supra* note 42.

294. *Id.*

295. One study indicates that startups should plan to raise enough money for 18 to 21 months of runway. Sebastian Quintero, *How Much Runway Should You Target Between Financing Rounds?*, J. OF EMPIRICAL ENTREPRENEURSHIP (Oct. 26, 2017), https://medium.com/journal-of-empirical-entrepreneurship/how-much-runway-should-you-target-between-financing-rounds-478b1616cfb5 [https://perma.cc/92UE-BYXE]. A Carta study indicates that startups should plan to raise at least twenty-four months of funding to ensure that there is enough money for the startup to operate before the next round of funding is raised. *See* Miguel Socias, *Raising Capital for Startups: How Long Does Funding Actually Take?*, CARTA

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downturn in the economy and inflation rose, fundraising rounds took place more frequently, particularly in hot areas like fintech, where there was an onslaught of funding led by nontraditional investors.[296] While the investments were still staged, the time between financings was shortened, and it appeared that war chests were being built. Consider that Ramp, a corporate credit-card startup founded in 2019, had four rounds of venture capital funding in less than eight months.[297] In its first round of financing, Ramp raised $25 million, led by the Founders Fund; Keith Rabois, a general partner at Founders Fund, joined its board of directors as part of the deal.[298] Ramp then raised $65 million at a $1.1 billion post-money valuation (value of a startup post-financing) in a second round of financing, which was led by D1 Capital Partners, a hedge fund; existing investors, Coatue Management and Goldman Sachs, and Stripe participated. Stripe then led another $50 million round at a $1.6 billion valuation.[299] Four months later, Ramp was valued in a fourth round at $3.8 billion.[300] Hedge funds—such as Altimeter, D1 Capital Partners, and Tiger—with specialized venture funds have been especially active in obtaining early stakes in such tech startups.[301]

Some companies, like Stripe (a payments company), also invest in startups with competing products. This brings up the issue of conflicts of interest. If Stripe has access to sensitive information from Ramp, is it possible (realistically) to ensure that it does not use that information for its own benefit or perhaps use its influence at

(May 23, 2017), https://carta.com/blog/getting-funded-how-long-does-it-actually-take/ [https://perma.cc/9NYS-FESN].

296. In 2020, U.S. fintech startups had a record year in VC funding—$20.5 billion. PITCHBOOK DATA, INC. & NAT'L VENTURE CAP. ASS'N, VENTURE MONITOR: Q4 2020, *supra* note 44, at 17.

297. Kate Clark, *Founders Fund, Iconiq Value Ramp at $3.8 Billion in New Funding Round*, THE INFO. (July 29, 2021, 3:25 PM), https://www.theinformation.com/articles/founders-fund-iconiq-value-ramp-at-3-8-billion-in-new-funding-round?rc=j8xyfa [https://perma.cc/7HQB-SDSG].

298. *Id.*

299. Berber Jin & Kate Clark, *Stripe Invests in Brex Rival Ramp at $1.6 Billion Valuation*, THE INFO. (Mar. 29, 2021, 12:28 PM), https://www.theinformation.com/articles/stripe-invests-in-brex-rival-ramp-at-1-6-billion-valuation?rc=j8xyfa [https://perma.cc/UZM8-YMBP].

300. Clark, *Founders Fund*, *supra* note 297.

301. D1 led one of Ramp's financing rounds. "It's also another instance of hedge funds and other nontraditional private tech investors taking stakes in early-stage companies in hopes of earning outsize returns." Jin & Clark, *Stripe Invests in Brex Rival Ramp*, *supra* note 299.

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the startup to scuttle a particular project that may be a competitor? For example, a few years ago, Stripe launched its own corporate card, yet it invested in Ramp, which produces a similar product.[302] Stripe invests in such companies to "gain insights into early-stage companies and potential acquisition targets."[303] The investment could also lead to potential business opportunities as Ramp could use Stripe's network to issue its corporate cards instead of Marqueta (its current provider).[304] CVCs "may be investing in companies that directly compete . . . or that have a direct correlation to the work of the parent company of the CVC."[305]

CVC is now a major player in the venture capital ecosystem and has impacted private ordering.[306] In the past, founders of the startups and venture capital funds (and the limited partners which provided the financial backing for such funds) were the focus of legal scholarship on private ordering in the VC context.[307] Professor Gilson discussed five organizational and contractual techniques to respond to the three central problems of financial contracts of "uncertainty, information asymmetry, and opportunism in the form of agency costs":[308] "staged financing, allocation of elements of control, form of compensation, the role of exit, and reliance on implicit contracts[.]"[309] However, not all of these techniques apply equally to nontraditional investors. Consider, for example, that staged financings are getting ever larger at even earlier stages of

302. *Id.*

303. *Id.*

304. *Id.*

305. Fan, *Catching Disruption*, *supra* note 8, at 373. CVCs are also increasingly sitting on board of directors, which impact control mechanisms effectuated by venture capital financing documents and may lead to conflicts of interest. *Id.*

306. *Id.* at 358. *See generally*, *The 2021 Mid-Year Glob. CVC Rep.*, CB INSIGHTS, https://www.cbinsights.com/reports/CB-Insights_CVC-Report-H1-2021.pdf? [https://perma.cc/79SB-FGT7] (last visited Sept. 28, 2022) (noting new heights of CVC investment in the first half of 2021).

307. *See generally* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (2d ed., 2004); Ronald J. Gilson, *Engineering a Venture Capital Market.: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003); Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003).

308. Gilson, *Engineering a Venture Capital Market*, *supra* note 307, at 1076.

309. *Id.* at 1078.

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startups' growth.[310] Allocation of control also appears to lie increasingly with the founder, which could potentially lead to a less balanced board.[311]

With the addition of the nontraditional investors, the three factors that are required for a reputation market to operate effectively are also impacted:

> First, the party whose discretion will be policed by the market must anticipate repeated future transactions. Second, participants must have shared expectations of what constitutes appropriate behavior by the party to whom discretion has been transferred. Finally, those who will deal with the advantaged party in the future must be able to observe whether that party's behavior in past dealings conforms to shared expectations.[312]

Since many of the nontraditional investors are relatively new to the scene, they may not all be repeat players. Even those who are, such as private equity funds, are acting differently than they have in the past. Consider that they are now investing earlier in a company's lifecycle, whereas before, they were focused on the later stages. Furthermore, the behavior piece is in flux. Some of these nontraditional investors may want board seats while others do not. Some may take a hands-off approach; others may want to be actively involved. Past dealings may also not be an indicator of future dealings as both traditional venture capital firms and nontraditional investors alike changed the valuations of financings to historic highs, wanted to invest in earlier stages and/or in every stage of the company, offered different types of services, and even invested in competitors of the startups at times when the economy was favorable.[313] Now, in an economic downturn, nontraditional investors may want to renegotiate deal terms even after signing a term sheet, which is not the behavioral norm for venture capital financings. "It's rare for startup investors that sign investment agreements, or term sheets, with founders to later change their

310. Derek Zanutto, *How Growth Investing Grew So Big So Quickly*, TECHCRUNCH (Nov. 5, 2020, 6:30 AM), https://techcrunch.com/2020/11/05/how-growth-investing-grew-so-big-so-quickly/ [https://perma.cc/3FNY-NU94].

311. Fan, *The Landscape of Startup Corporate Governance*, *supra* note 34.

312. Fan, *Catching Disruption*, *supra* note 8, at 382.

313. Berber Jin, *An Old VC Taboo Fades: More Firms Invest in Rivals*, THE INFO. (Aug. 6, 2021, 6:00 AM), https://www.theinformation.com/articles/an-old-vc-taboo-fades-more-firms-invest-in-rivals [https://perma.cc/7TY3-KTWV].

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minds about the price. But investors expect such negotiations to become more common . . . as the private market continues to adjust to the declines of tech stocks . . . ."[314]

E. Political Concerns

One category of nontraditional investors, sovereign wealth funds, also brings a host of unique issues. For those startups that receive investments from sovereign wealth funds, "the most prominent concerns raised relate to SWFs' objectives and possible investment practices."[315] For example, "there are concerns that . . . political or 'noncommercial' objectives" may drive sovereign wealth funds' investments.[316] If investments are viewed as jeopardizing national security, they may be the subject of "arbitrary or targeted regulations on foreign investments and takeovers."[317] Furthermore, if commitments are guaranteed (or perceived to be) by the government, that also raises concerns.[318] Although not unique to sovereign wealth funds, regulatory arbitrage is another "parallel concern . . . with SWF investments being directed to the host countries with the lightest restrictions."[319] "Reduce[d] . . . effectiveness of corporate governance of the companies in which [SWFs] invest" is also another concern that is highlighted with views ranging from SWFs having too much influence to being too passive.[320] There are concerns about the lack of transparency with sovereign wealth funds as well.[321] These concerns may be ameliorated in certain instances, however. In terms of corporate governance, investment activities of sovereign wealth funds may be subject to securities regulation by the agencies of countries in which the startup is located.[322] In the United States, for example, if a sovereign wealth fund acquires 5% of shares in a publicly traded company, it needs to report its ownership interest to such

314. Jin & Clark, *Tiger Global, Alkeon Slash*, *supra* note 165.
315. *Sovereign Wealth Funds – A Work Agenda*, *supra* note 171, at 14.
316. *Id.* at 15.
317. *Id.*
318. *Id.*
319. *Id.*
320. *Sovereign Wealth Funds – A Work Agenda*, *supra* note 171, at 15.
321. *Id.* at 4.
322. *Id.* at 19.

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company as well as the SEC.[323] Furthermore, if a company—startup or otherwise—implicates U.S. national security, the Committee on Foreign Investments in the United States will review the transaction.[324] However, because of the general lack of reporting obligations for startups, there is little transparency with respect to sovereign wealth funds.

One of the most well-known examples of a sovereign wealth fund is the nearly five-decades-old Saudi Arabian government's Public Investment Fund.[325] With more than $360 billion in assets, it

323. Ethiopis Tafara, *Testimony Concerning the Regulatory Framework for Sovereign Investments,* U.S. SEC. & EXCH. COMM'N (Apr. 24, 2008), https://www.sec.gov/news/testimony/2008/ts0342408et.htm [https://perma.cc/9A9T-NM8U].

324. The review process of the Committee on Foreign Investment in the United States was amended by the Foreign Investment Risk Review Modernization Act which was incorporated into the John S. McCain National Defense Authorization Act for Fiscal Year 2019; the U.S. government now has more power to review foreign investments, even minority non-controlling ones. *See* John Cornyn, *Cornyn, Feinstein, Burr Introduce Bill to Strengthen the CFIUS Review Process, Safeguard Nat'l Security*, VOTE SMART (Nov. 8, 2017), https://votesmart.org/public-statement/1204881/cornyn-feinstein-burr-introduce-bill-to-strengthen-the-cfius-review-process-safeguard-national-security#.XDhyeC2ZPEZ [https://perma.cc/LY6A-GE9F]; *Final CFIUS Regulations Implement Significant Changes by Broadening Jurisdiction and Updating Scope of Reviews*, SHEARMAN & STERLING (Jan. 14, 2020), https://www.shearman.com/Perspectives/2020/01/Final-CFIUS-Regulations-Implement-Changes-by-Broadening-Jurisdiction-and-Updating-Scope-of-Reviews [https://perma.cc/UZ5S-M5FA]; *See generally*, *CFIUS Laws & Guidance*, U.S. DEP'T OF THE TREAS., https://home.treasury.gov/policy-issues/international/the-committee-on-foreign-investment-in-the-united-states-cfius/cfius-laws-and-guidance [https://perma.cc/PGV4-S7JT] (last visited Sept. 28, 2022); 31 C.F.R. § 800 (2020); 31 C.F.R. § 801 (2018); Foreign Investment Risk Review Modernization Act of 2018, S. 2098, 115th Cong. (2018). The venture capital financing documents may also include representations related to CFIUS. For example, in the NVCA Stock Purchase Agreement, provision 2.30 addresses CFIUS representation and states:

> The Company does not engage in (a) the design, fabrication, development, testing, production or manufacture of one (1) or more 'critical technologies' within the meaning of the Defense Production Act of 1950, as amended, including all implementing regulations thereof (the 'DPA'); (b) the ownership, operation, maintenance, supply, manufacture, or servicing of 'covered investment critical infrastructure' within the meaning of the DPA (where such activities are covered by column 2 of Appendix A to 31 C.F.R. Part 800); or (c) the maintenance or collection, directly or indirectly, of 'sensitive personal data' of U.S. citizens within the meaning of the DPA. The Company has no current intention of engaging in such activities in the future.

Model Legal Documents, Stock Purchase Agreement, *supra* note 239.

325. Emily DeCiccio, *Crown Prince's Actions in Khashoggi Killing Leave Saudi Fund Vulnerable, Ex-Obama Official Says*, CNBC (Feb. 26, 2021, 5:19 PM), https://www.cnbc.com/2021/02/26/saudi-fund-vulnerable-after-mbs-actions-in-khashoggi-killing-ex-obama-official-says.html [https://perma.cc/F8KA-KZ9X]. In a declassified report, the U.S. Office of the Director of National Intelligence "assess[ed] that [he] approved an operation in Istanbul, Turkey to capture or kill Saudi journalist Jamal Khashoggi." *Assessing the Saudi Government's*

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is the eighth largest sovereign wealth fund in the world, based on total assets. In 2016, it invested $45 billion in SoftBank's $100 billion Vision Fund.[326] However, after a news report tying a journalist's murder to the Saudi prince, the startup community distanced itself from this particular sovereign wealth fund.[327] The release of a previously classified intelligence report, which appeared to confirm the involvement of the Crown Prince of Saudi Arabia, Mohammed bin Salman Al Saud in the Khashoggi killing, could be grounds for a human rights violation; theoretically, this could lead to sanctions under the Global Magnitsky Human Rights Accountability Act ("Magnitsky Act").[328] Under the Magnitsky Act, the President has the authority "to impose economic sanctions and deny entry into the United States to any foreign person identified as engaging in human rights abuse or corruption."[329] Should such sanctions be imposed, this would undoubtedly have an adverse impact on the Public Investment Fund. It is also a stark reminder of how politics can play a role in this type of nontraditional investor.

Role in the Killing of Jamal Khashoggi, OFF. DIR. NAT. INTEL. 2 (Feb. 11, 2021), https://www.dni.gov/files/ODNI/documents/assessments/Assessment-Saudi-Gov-Role-in-JK-Death-20210226v2.pdf [https://perma.cc/MS26-PG9B].

326. Isobel Asher Hamilton, *Saudi Arabia Is Reportedly Talking to SoftBank About Pouring Billions into Its Second Vision Fund*, BUS. INSIDER (Oct. 28, 2019, 8:27 AM), https://www.businessinsider.com/saudi-arabia-reportedly-considers-investing-in-softbank-vision-fund-2-2019-10 [https://perma.cc/AM8S-E5W3].

327. Emily DeCiccio, *Crown Prince's Actions in Khashoggi Killing*, *supra* note 325. Jackie Northam, *Investors Are Back in Saudi Arabia a Year After Khashoggi's Killing,* NPR (Oct. 2, 2019, 3:41 PM), https://www.npr.org/2019/10/02/766494653/investors-are-back-in-saudi-arabia-a-year-after-khashoggis-killing [https://perma.cc/NEF2-YGHC]. *See also* Julie Steinberg, *Norway's Massive Sovereign Wealth Fund to Exit Russian Holdings*, WALL ST. J. (Feb. 27, 2022), https://www.wsj.com/livecoverage/russia-ukraine-latest-news-2022-02-26/card/WjZEyWVHvGe6XhwOLGCr [https://perma.cc/JC47-GPRR]. The world's largest sovereign wealth fund, Norges Bank Investment Management, a $1.3 trillion fund of the Norwegian central bank, announced plans to divest its Russian holdings which are worth $3 billion due to Russia's attack on Ukraine; it does not appear that it invested in Russian startups. *Id.* Norges Bank Investment Management is formally known as the Government Pension Fund Global and was founded with revenue from Norway's oil and gas resources. NORGES BANK INV. MGMT. https://www.nbim.no/ [https://perma.cc/E2MS-Y2YB] (last visited Sept. 28, 2022).

328. *The Global Magnitsky Human Rights Accountability Act*, CONG. RSCH. SERV. (Oct. 28, 2020), https://crsreports.congress.gov/product/pdf/IF/IF10576#:~:text=The%20Global%20Magnitsky%20Human%20Rights%20Accountability%20Act%20(Global%20Magnitsky%20Act,human%20rights%20abuse%20or%20corruption [https://perma.cc/6NJA-4NFZ].

329. *Id.*

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F. Impact on the Public-Private Divide

The participation of nontraditional investors in venture capital financings—a domain that has historically been dominated by traditional venture capital firms—also hastened the breakdown of the public-private divide. As nontraditional investors continued to invest at breakneck speeds with high valuations and in record-setting amounts with little to no disclosure required, it impacted not only the venture capital ecosystem but the economy more broadly. Consider that a mutual fund that is investing on behalf of pension funds, among others, can use various exemptions to keep its investment private. Consider further that mutual funds typically invest in the later stages of a startup and likely contribute to the high valuation (some may argue inflated valuation) of the startup, which results in it becoming a unicorn. As many scholars have argued, there should be more transparency, particularly with respect to unicorns, for various reasons ranging from investor protection to stakeholder-oriented disclosure.[330] Otherwise, an influential segment of the U.S. economy is "going dark."[331] And now, with some traditional venture capital firms changing their legal structures to allow them to participate in the public market, an even stronger case can be made that the private-public divide will likely cease to exist in any meaningful way.

III. NORMATIVE IMPLICATIONS OF THE RISE OF NONTRADITIONAL INVESTORS

In the past, it was much more difficult to start companies. Now, "[t]he broad-based knowledge among entrepreneurs of how to start successful companies has been widely distributed."[332] The infrastructure to support startup building is in place and "price risk

330. *See, e.g.*, Jennifer Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583 (2016) [hereinafter *Regulating Unicorns*]; Renee Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165 (2017); Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REG. 499 (2020); Elizabeth Pollman, *Private Company Lies*, 109 GEO. L. J. 353 (2020); Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663 (2020).

331. Allison Herren Lee, *Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy*, U.S. SEC. & EXCH. COMM'N (Oct. 12, 2021), https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12 [https://perma.cc/82FQ-SGP5].

332. Lessin, *The End of Venture Capital*, *supra* note 28.

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has gone mainstream."[333] In other words, the market is becoming more efficient, but investing may become less profitable.[334] To win deals, high valuations and favorable terms for startups are a must.[335] A few things have happened as a result: more capital is needed to compete[336] and traditional venture capital firms (at least the ones who survive) "will look more and more like every other global financial shop."[337] This Part first addresses how traditional venture capital firms have evolved (or not) in the wake of the rise in the number and influence of nontraditional investors. In doing so, it demonstrates that traditional venture capital firms may no longer operate under the confines of the legal definition of venture capital fund.[338] It then points out how certain trends in venture capital have had a lasting impact on how venture deals are structured and run. In turn, these trends have impacted corporate governance in venture capital-backed private companies. Lastly, this Part provides suggestions for reform, proposing changes to the broader venture capital ecosystem that encompass both traditional venture capital firms and nontraditional investors.

A. How Traditional Venture Capital Firms Have Evolved

This Section will discuss three different models of venture capital firms in particular—Sequoia Capital ("Sequoia"), Benchmark, and Andreessen Horowitz—to contrast the different approaches and legal forms venture capital firms have taken in the face of an increasingly competitive landscape.

333. *Id.*

334. *Id.*

335. *Id.*

336. One commentator speculates, "Access to cheap money—through relationships with the world's largest limited partners and sovereign wealth funds—is going to be the biggest determinant of success." *Id. See, e.g.*, Kate Clark & Kaya Yurieff, *Lightspeed Targets Over $5.5 Billion for New Funds*, THE INFO. (Oct. 28, 2021, 6:00 AM), https://www.theinformation.com/articles/lightspeed-targets-over-5-5-billion-for-new-funds?utm_campaign=article_email&utm_content=article-6476&utm_source=sg&utm_medium=email&rc=j8xyfa [https://perma.cc/N2RN-RJ3H] (noting that Lightspeed is raising a $5.5 billion fund focused on early- and late-stage investments; it last raised $4.2 billion across three funds in 2020).

337. Lessin, *The End of Venture Capital*, *supra* note 28.

338. *See* discussion *supra* notes 45–55.

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1. Sequoia Capital

Recently, Sequoia differentiated itself from its rivals by announcing that all of its U.S. and European investments will be held in a single fund, the Sequoia Fund, which "will serve as an open-ended capital vehicle and become the sole limited partner for all future Sequoia 'sub-funds' (seed, venture, growth, etc.)."[339] This is significant because although "[v]enture capital is the money of innovation, . . . the industry itself rarely innovates."[340] In other words, instead of time-limited funds, Sequoia will have one open-ended fund.[341] As a result, "it can start to operate as the sum of all its [assets under management]."[342] With a master fund, there is also one limited partner, Sequoia, which eliminates the need to run many funds with managers and strategies that may differ.[343]

Typically, venture capitalists leave company boards once they go public and sell the fund's shares as soon as possible so they can distribute the profits to the limited partners who invested in the fund.[344] Under this new structure, however, Sequoia could stay on company boards long after they go public, hold on to their shares

339. The sub-funds will continue to charge a 30% carried interest (the typical charge is 20%) and the Sequoia Fund will charge a less than 1% yearly management fee along with a long-term performance fee. Dan Primack, *Top of the Morning*, AXIOS PRO RATA (Oct. 26, 2021), https://www.axios.com/newsletters/axios-pro-rata-9f49ecb5-6725-4fc7-9b66-97d2cf2517ee.html [https://perma.cc/KEC2-M85X].

340. *Id.*

341. "[M]eaning it never has to return capital unless limited partners explicitly choose to redeem. The metafund will allocated funds to more traditional-looking VC subfunds for venture investing." Sam Lessin, *What Sequoia Gains by Blowing Up the VC Fund Structure*, THE INFO. (Oct. 27, 2021, 12:00 PM), https://www.theinformation.com/articles/what-sequoia-gains-by-blowing-up-the-vc-fund-structure?utm_medium=email&utm_campaign=article_email&utm_content=article-6470&utm_source=sg&rc=j8xyfa [https://perma.cc/9T62-HSQA].

342. *Id.* "Most financial institutions talk about AUM as the net asset value of all of the investments they manage. Venture capitalists, however, typically talk about AUM in terms of how much money they've raised versus the value of their investments. One way to think about the move here is that Sequoia is basically framing AUM as other financial institutions do." *Id.*

343. *Id. But cf.* Kate Clark, *No Longer Just Crypto Curious, Sand Hill Road Investors Get Blockchain Fever*, THE INFO. (Oct. 22, 2021, 6:01 AM), https://www.theinformation.com/articles/no-longer-just-crypto-curious-sand-hill-road-investors-get-blockchain-fever?utm_term=popular-articles&utm_source=sg&utm_medium=email&utm_campaign=article_email&utm_content=article-6466&rc=j8xyfa [https://perma.cc/L29X-CYXZ] (noting the increase in crypto-focused funds).

344. "In terms of LPs, Sequoia believes the traditional fund structure has prompted it to sell shares too early (including in companies like Google). One internal analysis of distributions over the past 15 years shows that had Sequoia held onto shares for just 12 additional months, it would have resulted in over $8 billion in added returns." Primack, *Top of the Morning*, *supra* note 339.

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as long as they want, and get involved with potentially even more lucrative deals. Sequoia partner, Roelof Botha, explained, "We think the VC model is outdated[.] . . . It creates an odd dynamic between us and founders, where on the eve of an IPO[,] they're asking if we're going to have to get off their boards and quickly distribute the stock. Why should that be the default, particularly when so much value creation happens later?"[345] Put differently, by creating this new structure, Sequoia wants to better align its interests with its founders and limited partners.[346] Furthermore, in order to broaden its investments in crypto and secondaries, Sequoia intends to become a registered investment advisor.[347] As a registered investment advisor, Sequoia is not subject to the ten-year fund lifecycle that is typical of venture funds, nor is it limited to a 20% cap for investment in non-qualifying investments; this allows Sequoia to invest more into these other asset classes, such as cryptocurrencies.[348] Under Sequoia's new fund structure, the first three sub-funds will be a \$500–\$600 million crypto fund, a \$900–\$950 million ecosystem fund (which is a fund of funds to help Sequoia alumni-founded funds, Sequoia scouts, and third-party efforts), and a \$3.2–\$3.5 billion expansion fund focused on U.S. and European companies.[349] Sequoia's new structure is not without its own risks, however, as it will subject them to the vicissitudes of the market.[350]

There are differing schools of thought about whether other venture capital firms will join Sequoia in forming one big open-ended fund. One venture capitalist opined, "[M]ost don't have the brand, LP relationships, or balance sheet to take the same step. I don't think others will rush to adopt this model."[351]

345. *Id.*

346. *Id.*

347. *Id.* Most venture capital firms are exempt reporting advisors. VENTURE MONITOR: Q4 2021, *supra* note 16, at 30.

348. VENTURE MONITOR: Q4 2021, *supra* note 16, at 30.

349. Dan Primack, *Sequoia Capital Launches Crypto Token Fund*, AXIOS (Feb. 17, 2022) https://www.axios.com/2022/02/17/sequoia-capital-crypto-token-fund [https://perma.cc/6CX3-LCJE].

350. Dan Primack, *Top of the Morning*, *supra* note 339.

351. Lessin, *What Sequoia Gains*, *supra* note 341. PitchBook predicts that three other venture capital firms will join Sequoia in restructuring their funds. VENTURE MONITOR: Q4 2021, *supra* note 16, at 30.

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One of the concerns this new model raises within the board context is that typically the board members who are partners at traditional venture capital firms leave the board once it becomes public. There are a few reasons for this. First, they will not meet the definition of "independent director" as a public company.[352] Second, it is unclear whether they have the skillset to perform the functions of a public company director.[353] Third, conflicts of interest may arise if they are investing in startups in similar spaces, so that may impact their ability to weigh in on certain board decisions.[354]

2. Benchmark

Although there are those like Andreessen Horowitz and Sequoia Capital who are adapting to the reality of an ever-competitive space by offering more services or structuring themselves differently from a legal standpoint, some, like Benchmark, are generally doing deals at the same fund size and pace as before.[355] Benchmark has historically focused on early-stage investing, but in one possible change to respond to the changing venture capital environment, it is now contemplating whether it should invest more in its existing portfolio companies at later-stage financing rounds.[356] Experts contend that venture capital "is bifurcating between specialist seed funds and a handful of giant,

352. Each exchange has its own rules to define the term "independent director." *See, e.g.*, *5600 Corporate Governance Requirements*, *IM-5605. Definition of Independence – Rule 5605(a)(2)*, NASDAQ, https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/nasdaq-5600-series [https://perma.cc/75XT-8JN4] (last visited Sept. 28, 2022); *303A.02 Independence Tests*, N.Y. STOCK EXCH. LISTED CO. MANUAL, https://www.ghco.com/static-files/60538d32-b4e0-481e-801c-2df74b4163c6 [https://perma.cc/K992-UBWT] (last visited Sept. 28, 2022); *NYSE American Board Independence Standards*, LAWCAST, https://lawcast.com/2020/01/19/nyse-american-board-independence-standards/ [https://perma.cc/7N3R-M5PG] (last visited Sept. 28, 2022); Sandys v. Pincus, 152 A.3d 124 (Del. 2016).

353. Steven E. Bochner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1 (2016) ("Even if a company has independent directors, a board may worry that the company does not have sufficient resources available for the committee to conduct the type of process that Delaware judges are used to seeing in the public company context.").

354. *See, e.g.*, *In re* Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).

355. Benchmark raises "a $400 to $500 million fund every two to four years as it focuses on landing large stakes in relatively few startups." Jin, *Benchmark's VC Model Strained*, *supra* note 5. *See generally* discussion on Benchmark *supra* Part II.

356. Under its pro rata rights as an existing investor, Benchmark could invest more to maintain its pro rata share in a startup, but it often invests less than it is allowed to. Jin, *Benchmark's VC Model Strained*, *supra* note 5.

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all-purpose firms. Traditional firms face more pressure than ever from the top and bottom of the funnel because of more sophisticated angel investor groups and non-VC giants like SoftBank's Vision Fund . . . .[357] The reason why Benchmark was selected as an example is because it has been one of the standard bearers of how venture capital operates. Whether it remains one, however, is an open question.

3. Andreessen Horowitz[358]

In recent years, some venture capital firms have enhanced their value-add and increased their ranks to do so.[359] Consider Andreessen Horowitz, which now has over 240 employees[360] and works on recruiting, marketing, and the like for its portfolio companies. Its website lists a dizzying array of services: capital network, go-to-market, talent network (which is divided into technical talent and executive talent), people practices, marketing, operations, board advisors, and special advisors.[361] In four years, its investment team has grown 170%, which is exponentially higher than its nearest venture capital rivals like Sequoia, Lightspeed, Accel, and General Catalyst; Andreessen Horowitz was roughly on par in terms of its investment team headcount with these other firms four years before.[362] Andreessen Horowitz's hiring splurge reflects the amount of money it has raised—$12.5 billion in three

357. Alex Konrad, *Andreessen Horowitz is Blowing Up the Venture Capital Model (Again)*, FORBES (Apr. 2, 2019, 9:40 AM), https://www.forbes.com/sites/alexkonrad/2019/04/02/andreessen-horowitz-is-blowing-up-the-venture-capital-model-again/?sh=33966bd47d9f [https://perma.cc/E2BM-EBH8].

358. In 2009, the pitch for Andreessen Horowitz's first venture capital fund "promised to find a new generation of 'megalomaniacal' founders—ambitious, assertive, singularly focused—who would, in the mold of CEO Steve Jobs, use technology to 'put a dent in the universe.'" *Id.*

359. *Cf.* Jin, *Benchmark's VC Model Strained*, *supra* note 5.

360. Kate Clark, *Greylock Raises $500 Million in Battle for Seed Deals*, THE INFO. (Sept. 21, 2021, 11:57 AM), https://www.theinformation.com/articles/greylock-raises-500-million-in-battle-for-seed-deals?utm_source=ti_app&tpcc=nltermsheet&rc=j8xyfa [https://perma.cc/6VV2-DMZD].

361. *Investing Team*, ANDREESSEN HOROWITZ, https://a16z.com/about/team/ [https://perma.cc/AR6J-BXEJ] (last visited Sept. 23, 2022) (there is no description of the actual jobs of the people in the different categories).

362. Mahira Dayal & Amir Efrati, *Andreessen Horowitz Investment Staff Grew 170% in Four Years*, THE INFO. (Oct. 20, 2021, 6:00 AM), https://www.theinformation.com/articles/andreessen-horowitz-investment-staff-grew-170-in-four-years?utm_source=sg&utm_medium=email&utm_campaign=article_email&utm_content=article-6438&rc=j8xyfa [https://perma.cc/LKT5-48C2].

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years.[363] It has outraised almost all the traditional venture capital firms and is close to the amount of money raised by Insight Partners, Coatue Management, and Tiger—some of the largest investors in the world who have traditionally focused on backing startups at a later stage.[364] Andreessen Horowitz also has registered investment advisors, which allows it to invest more of its funds into a greater range of investment vehicles: cryptocurrencies, public stocks, and secondary purchases.[365] One journalist described the Andreessen Horowitz structure as "modeled more on a Hollywood talent agency than a traditional venture capital firm."[366] The customary 2% in fees was put into growing the services team, "including experts in marketing, business development, finance and recruiting."[367] Some have even speculated that Andreessen Horowitz may go public.[368]

Andreessen Horowitz has raised increasingly larger funds to match the pace of its investments, "hoping to solidify its position in the industry for generations as the VC industry consolidates around fewer firms."[369] The firm has also accelerated its investment timeline—only Tiger is doing more deals than them on a weekly basis—and is increasingly funding startups it previously funded at ever higher levels, like Clubhouse, an audio chat app, TripActions, a business travel software company, and Substack, a publishing platform.[370] As a result, Andreessen Horowitz "has quickly and

363. *Id.*

364. *Id.*

365. *Andreessen Horowitz Registers as RIA*, PITCHBOOK (Apr. 3, 2019), https://pitchbook.com/newsletter/andreessen-horowitz-registers-as-ria?tpcc=nltermsheet [https://perma.cc/J4B6-U3M9] (secondary purchases and fund or token investments are considered to be "high risk" by the SEC and can comprise no more than 20% of a traditional venture capital fund). *General Information on the Regulation of Investment Advisers*, U.S. SEC. & EXCH. COMM'N (Mar. 11, 2011), https://perma.cc/M7E5-3T7P.

366. Konrad, *Andreessen Horowitz*, *supra* note 357.

367. *Id.*

368. Berber Jin, *Why Andreessen Horowitz Might Go Public*, THE INFO. (Nov. 3, 2021, 6:01 AM), https://www.theinformation.com/articles/why-andreessen-horowitz-might-go-public?utm_medium=email&utm_campaign=article_email&utm_content=article-6507&utm_source=sg&rc=j8xyfa [https://perma.cc/K5LA-VFK7].

369. Kate Clark & Amir Efrati, *'These Guys are Very Different': Inside Andreessen Horowitz's Rise*, THE INFO. (Apr. 16, 2021, 6:01 AM), https://www.theinformation.com/articles/these-guys-are-very-different-inside-andreessen-horowitzs-rise?preview=true&524ptimizely_disable=true&rc=j8xyfa [https://perma.cc/DK79-N4T4].

370. *Id.* (this practice was not very common before at Andreessen Horowitz but is for other firms).

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aggressively pushed up the prices of these portfolio companies."[371] As an example, in April 2020, it invested in Clubhouse at a $100 million valuation; then, in early 2021, it led a financing round valuing the startup at $1 billion.[372] In April 2021, a Series C round, which reportedly valued the company at $4 billion, closed; it was also led by Andreessen Horowitz.[373] This type of investment strategy does not come without risks. Its "bet-big-and-bet-often" *modus operandi* works in a bull market, but not if there's a downturn.[374]

Andreessen Horowitz also engages in the novel practice of the reverse pitch where "[a]fter the founders of especially hot startups pitch their product to Andreessen Horowitz partners, the partners pitch the founders on why the startups should take money from the firm."[375] The reverse pitch includes a promise of help with corporate development, marketing, public relations, and regulatory and recruiting issues.[376] The firm has also prioritized media efforts to elevate its portfolio companies.[377]

Since it was founded in 2009, Andreessen Horowitz has had a different playbook from the other traditional venture capital firms. Andreessen Horowitz's origins differentiate it from other firms: its founders "decided to develop the kind of VC firm they would have preferred to deal with as founders."[378] Their ambitions led them to "build a carbon copy of Creative Artists Agency, a talent agency created by Michael Ovitz that shook Hollywood by catering to the needs of movie and TV stars—only in their version the tech founders were the stars."[379]

Furthermore, Andreessen Horowitz was unusual in that it invested in every stage of the company and bought stock from employees in late-stage startups.[380] The firm also believed that a

371. *Id.*

372. *Id.*

373. Mike Butcher, *Clubhouse Closes an Undisclosed $4B Valuation Series C Round, as Tech Giants' Clones Circle*, TECHCRUNCH (Apr. 19, 2021, 4:34 AM), https://techcrunch.com/2021/04/19/clubhouse/ [https://perma.cc/KRJ3-6U72] (noting that DST Global, Tiger Global, and Elad Gil also participated).

374. Clark & Efrati, '*These Guys are Very Different*,' *supra* note 369.

375. *Id.*

376. *Id.*

377. *Id.*

378. *Id.*

379. *Id.*

380. *Id.*

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founder would be better suited to be CEO rather than a professional CEO.[381] It raised a $300 million fund for its first fund (a huge amount at the time) and immediately went on to raise a second fund.[382] Typically, the time between fundraising was a few years.

"The founder-friendly mantra was just right for the era. Andreessen Horowitz was formed at a time when entrepreneurs were eroding some of the power traditional VC firms had over them."[383] It was much cheaper to start a software company due to the internet and cloud computing, so the founders did not require as much capital at the beginning.[384] Also, there were more seed investors who would write small checks to new teams.[385]

Andreessen Horowitz has always been willing to pay more for startups than its counterparts, which appeared to give the firm average returns earlier on.[386] This approach, however, led to success in the long term—being willing to pay more for startups likely gave the firm a competitive advantage and may be one of the reasons hot startups flocked to Andreessen Horowitz. Databricks, an enterprise software firm, is just one of its success stories based on this strategy.[387]

B. Other Trends in Venture Capital Financings

Even with the advent of an economic downturn, nontraditional investors will remain on the startup scene, but outsized valuations and mega-rounds of financings will no longer be the norm. Nontraditional investors will likely continue to come in more frequently at the seed and early-stages of startups. Traditional venture capital firms will be forced to shift their playbook in response to the impact that nontraditional investors are having on the startup investment scene. Firms may implement legal and business changes similar to the ones that Sequoia and Andreessen Horowitz undertook. Changes are already occurring. Some firms

381. *Id.*
382. *Id.*
383. *Id.*
384. *Id.*
385. *Id.*
386. *Id.*
387. *Id.* Although Databricks only generated $1 million in annual revenue, it was valued at $500 million by Andreessen Horowitz and other investors in 2015; now, its yearly revenue is $500 million, and its valuation has multiplied by almost 60 times. *Id.*

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are raising increasingly larger funds and providing a plethora of services with their recently hired staff, while others are changing their legal structure altogether, as Sequoia did.[388]

In the past few years, traditional venture capital firms increasingly faced stiff competition from the nontraditional investors who were "often winning with speed, pricing and flexible investment terms."[389] While there are still ample funds for nontraditional investors to deploy in light of large fund sizes and fundraising efforts, the economic downturn will likely slow down the deal flow and lead to fewer investments and lower valuations.[390] Everyone will be more careful in these circumstances. Deal timeframes will lengthen, and flat rounds or down rounds will be more commonplace. Investor directors will once again wield more power, which may put traditional venture capital firms at an advantage; if the lead investor is at such a firm, they typically require board seats as part of the terms of the financing—most nontraditional investors, such as mutual funds, do not. However, the participation of nontraditional investors in financings may impact contractual rights. Consider that in one empirical study, the authors found that financing rounds with mutual funds have less board representation than traditional venture capital firms but stronger redemption and IPO-related rights, "all of which improve the liquidity of the underlying securities . . . ."[391] Separately, if nontraditional investors renege on deal terms after term sheets are signed, this may lead to more deal opportunities for traditional venture capital firms which historically have not engaged in such behavior.[392] One venture capital firm, Tribe Capital, characterized nontraditional investors as "fast money," noting that

388. Lessin, *What Sequoia Gains*, *supra* note 341. *See* discussion *infra* Section III.A.1.

389. Jin, *Benchmark's VC Model Strained*, *supra* note 5.

390. "Total VC investment falls during economic downturns too, because funds behave more cautiously and conserve cash for their portfolio companies. From 2007 to 2009, for example, total U.S. VC investments dropped 28%." Kate Clark, *Amid Downturn, Silicon Valley's Balance of Power Shifts from Startups to VCs*, THE INFO. (Apr. 3, 2020, 7:00 AM), https://www.theinformation.com/articles/amid-downturn-silicon-valleys-balance-of-power-shifts-from-startups-to-vcs?rc=j8xyfa [https://perma.cc/8GYR-KEPH].

391. Chernenko, Lerner & Zeng, *Mutual Funds as Venture Capitalists*, *supra* note 135, at 42. The IPO-related rights include "IPO ratchets that promise investors a certain return in an IPO, and veto rights on IPOs with lower valuations that [sic] the current financing round . . . ." *Id.* at 5.

392. It may also create a situation where the "braiding" of formal and informal contract mechanisms may be less likely to happen due to the absence of trust. Ronald J. Gilson,

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> [they] can come in quickly, sometimes opportunistically or for transactional reasons, and also trade out quickly . . . These "fast" money firms are not in the business of venture capital [or] interested in helping with company building in the long run. They are . . . commonly referred to as "fair-weather friends."[393]

Venture capital firms typically focus on a particular stage of a company's development, but some are now investing in every stage.[394] They have also dramatically increased the amount of money they raise for each of their funds and are increasingly focused on early-stage investments. Greylock Partners, which was an early investor in Facebook and LinkedIn, raised $500 million for seed deals—the first outside money that startups take.[395] Historically, Greylock has focused on Series A and Series B deals, which follow seed deals if the startup is successful in its fundraising efforts.[396] Notably, it plans to invest up to $20 million in seed deals—which is far higher than the $2.6 million median seed deal size.[397] Sequoia and Andreessen Horowitz similarly raised large funds dedicated to seed investments.[398] "These firms are chasing the larger percentage of the shares typically sold in a seed deal. Investment firms can buy 10% or more of a business at the seed

Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1384 (2010) (explaining what the braiding of formal and informal contracts entails).

393. Clark, Amid Downturn, *supra* note 390. *Cf*. Hodgson, supra note 95 (describing CVCs as having "significantly increased their presence" over the last decade).

394. "'What was once a narrowly defined venture capital asset class has now expanded to multistage private tech investing . . . .'" Clark, *SoftBank*, *supra* note 3.

395. The $500 million is intended to expand a $1.1 billion fund to $1.6 billion. Clark, *Greylock Raises $500 Million*, *supra* note 360.

396. *Id.*

397. Greylock's large checks are "to avoid overexerting its staff . . . ." *Id.*

398. Andreessen Horowitz announced a $400 million fund for seed deals in August 2021. These seed-funded companies would have access to the firm's advisory group of seed-stage companies in the firm's portfolio as well as hiring assistance and educational resources. Kate Clark, *Andreessen Horowitz Announces $400 Million Seed Fund*, THE INFO. (Aug. 27, 2021, 4:21 PM), https://www.theinformation.com/briefings/3606f9?utm_source=google&utm_medium=cpc&utm_campaign=11543929116_112520154917&utm_content=477036477316&utm_term=dsa-419449938426&gclid=EAIaIQobChMI65SWnona8wIVizytBh3ZswvNEAAYASAAEgKGVPD_BwE&rc=j8xyfa [https://perma.cc/B2SJ-XTF5]. Sequoia Capital launched a $195 million seed fund—its fourth such fund. Lucinda Shen, *Sequoia Capital Raises $195 Million for Its Newest Seed Fund*, FORTUNE (Feb. 25, 2021, 8:39 AM), https://fortune.com/2021/02/25/sequoia-capital-raises-195-million-for-its-newest-seed-fund/?utm_source=email&utm_medium=newsletter&utm_campaign=termsheet&utm_content=2021092215pm&tpcc=nltermsheet [https://perma.cc/B2GR-VY9K]. Clark, *Greylock Raises $500 Million*, *supra* note 360.

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stage for much less capital and can continue building up that stake over time by participating in subsequent financings."[399] In turn, startups themselves also need to sell fewer shares to raise the capital that they need to develop their product.[400]

Although the pandemic put a damper on the growth in many industries and initially caused a downturn in fundraising, it ultimately fueled a surge of activity in the technology industry due to "unprecedented demand for tech services, driving new money into funds focused on private tech investments."[401] This demand then led to larger fund sizes.[402] In addition, low interest rates and the increasing value of public tech stocks drove money managers to invest in VC funds.[403] While it is too early to predict the full impact of the recent economic downturn on nontraditional investors, it is unlikely that they will continue to invest at the rate that they have in the past. Nonetheless, with the assets under management held by nontraditional investors, it is likely that they will remain influential.

C. Corporate Governance Implications

From a corporate governance perspective, the proliferation of nontraditional investors earlier on in the lifecycle of a startup may impact the board structure in potentially significant ways. If a nontraditional investor is the lead investor and does not require a board seat, it could potentially be problematic in a few ways. First, there would be no investor directors to hold the founder-management directors in check. Part of the appeal of traditional venture capital firms is that when they serve in a director capacity, they can bring the perspective of their experience with other portfolio companies.[404] Corporate governance may fail if classes of people are not represented.[405] Second, founders can sometimes have a myopic view.[406] Investor directors can help founders focus

399. Clark, *Greylock Raises $500 Million*, *supra* note 360.

400. Jin, *Benchmark's VC Model Strained, supra* note 5.

401. Clark, *SoftBank*, *supra* note 3.

402. *Id.*

403. *Id.*

404. *See* Fan, *The Landscape of Startup Corporate Governance*, *supra* note 34, at 347.

405. *Id.* at 339–45, Interview with Lawyer #15 (detailing interview methodology and noting that thoughts and concerns may not get airtime).

406. *Id.* at 324.

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on important matters. For example, they are focused on runway, burn rate, and hiring more than founders are;[407] they "[d]o a great job of normalizing corporate practice."[408] They standardize what is normal and have market checks.[409] Importantly, investor directors force founders to make decisions even if they are difficult.[410] If there are not as many investor directors or an absence of them, important decisions may not get made, or the company may focus on the wrong things. Independent directors play a secondary role when compared to investor directors and management-founder directors, so it is unlikely that they could help to offset any imbalance on the board.[411] In addition, independent directors do not join the board until the Series B or Series C stage.[412] Third, some nontraditional investors may want observer rights. Although it is common to have observers during board meetings, it is prudent for the board to consider how many people are in the boardroom.[413] The number of people on the board can change the tenor of the conversation.[414]

Even if a nontraditional investor has a board seat, there may be conflicts of interest. For example, if a corporate venture capitalist serves on the board, the company of the corporate venture capitalist may be a potential competitor.[415] This type of situation can be tricky as there may be some parts of the conversation where the director needs to recuse herself because of potential conflicts of interest and confidentiality reasons.[416]

The speed of deals also brings its own set of challenges. As discussed in Section C above, little time may be allocated to due diligence, and law firms may forego doing a legal opinion.[417]

407. *See id.* at Interview with Lawyer #19.

408. *Id.* at Interview with Lawyer #11 (ensuring that individuals do not have inappropriate vesting schedules; they want the company to be viewed as "investable").

409. *Id.*

410. *Id. (*citing example of having the business pivot).

411. *Id.* Independence in the private company context does not have the same meaning as in the public company context. Typically, independent directors are selected by mutual agreement of the founder-management directors and investor directors. *Id.* at 323.

412. *Id.* at 356.

413. *Id.* at Interview with Lawyer #19.

414. *Id.* at 388.

415. *Id.* at Interview with Lawyer #19.

416. *Id.* at Interview with Lawyer #1.

417. *See supra* Section II.B.

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Consider that if it was later discovered (after a financing) that there was an insufficient number of shares that were authorized, then there would need to be a rescission offer. This type of scenario is not outside of the realm of possibility, especially if startups do not hire experienced counsel early on to help ensure that the capitalization table is correct and that the shares issued have been appropriately approved.[418] One of the bright spots of the economic downturn may be that it serves as a forcing function to slow down deal timelines and signals a return to the prior cadence of deals which allowed for more time for due diligence.

D. Potential Areas for Reform

This Section offers suggestions for reform in light of the advent of nontraditional investors and changes in practices and legal structures in some traditional venture capital firms. Although the scope of most of these proposals is modest, even incremental changes to corporate governance in the venture capital ecosystem have the potential to impact startup corporate governance in meaningful ways.

First, startup boards should strive to have different voices representing various interests in the boardroom, even if lead investors do not bargain for a board seat. A recent study illustrated that in the first round of financing, the founders (referred to as entrepreneurs in the study) have control of the board; in the second round, the control is either shared between the founder and those who provided venture capital or is controlled by venture capital; and "in the fourth round of financing, venture-capital control is most common . . . ."[419] As prior scholarship has shown, each of the directors (founder director, investor director, and independent director) has a particular role to play at particular junctures in the lifecycle of the startup.[420] Admittedly, if founders, especially first-

418. *See* Fan, *The Landscape of Startup Governance*, *supra* note 34. Interview with Lawyer #19 (observing that experienced counsel can head off a lot of challenges at the outset, including the proper issuance of shares and assignment of intellectual property rights).

419. Michael Ewens & Nadya Malenko, *Board Dynamics Over the Startup Life Cycle*, VOXEU (Aug. 8, 2020), https://voxeu.org/article/board-dynamics-over-startup-life-cycle [https://perma.cc/G5CG-XR4D] (noting that the increased amount of private capital due to the growth in investments by nontraditional investors has also increased startup founders' bargaining power).

420. *See generally* Fan, *The Landscape of Startup Corporate Governance*, *supra* note 34, at 324–39 (discussing the benefits and shortcomings of each type of director and how they work together).

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time entrepreneurs, have control over the board, they may be reluctant to give up such control even as the company has subsequent rounds of financing. However, experienced counsel and trusted advisors (such as the nontraditional investors who do not take on a board role) could help to guide them in the right direction. Furthermore, it would serve the health of the company in the long term.

Second, potential conflicts of interest with nontraditional investors should be carefully monitored and addressed. In the past, with so much available capital, this is an issue that may have been glossed over to the detriment of the startup. Again, lawyers have a significant role to play in this instance as they are equipped to identify and make certain that the appropriate process is followed and documented to prevent problems in the future. This is more likely to happen during economic downturns where corporate governance is given more attention.[421]

Third, there should be a sufficient timeline built into term sheets to ensure that proper due diligence can be conducted. As one investor cautioned, "'Don't allow the hype of the market to not let you read what the diligence is telling you . . . .'"[422] Alternatively, the representations and warranties that the startup makes in the financing documents can serve as insurance for the investors in the event that the startup was not aboveboard or sloppy. In this way, the risk can be allocated to the startup. If the founders of startups have increased bargaining power,[423] however, startups may have more leverage to negotiate the terms that they want.

Fourth, more transparency around deal terms, finances, and those who serve on the board would be helpful.[424] One of the recurring themes in both the business and legal scholarship in this area is the opaqueness of private companies. As discussed earlier, this has led to the breakdown of the public-private divide.[425] Scholars typically comb publicly available archives to gather

421. *Id.* at 374–81 (discussing the difference in the behavior of the board and investors in an economic downturn).

422. Thorne, *supra* note 14.

423. Ewens & Malenko, *Board Dynamics*, *supra* note 418 (noting that the increased amount of private capital due to the growth in investments by nontraditional investors has also increased startup founders' bargaining power).

424. *Regulating Unicorns, supra* note 330.

425. *See* discussion *supra* Part I.

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information, survey venture capitalists, or interview startup lawyers to better understand how private companies operate because the information is simply not available other than to a select group of investors.[426] More information about these companies and the investors who invest in them would benefit employees who often receive equity as part of their compensation packages.

Although this Section has identified several options to reduce the likelihood of corporate governance issues in the future, each of them depends on the willingness of the founders to defer to the counsel of their lawyers or to relinquish some of the founder-friendly terms. Bad economic times could also serve as a forcing function since the board power shifts to the investor directors; also, founders would be required to offer more favorable terms to investors and more equity for less money. A more aggressive option is available in the form of regulatory reform if tailored to startups of a particular size, such as unicorns. As an example, it appears that the SEC is open to the idea of subjecting larger private companies to more regulation.[427] This would be a good first step that many academics have already advocated for.[428] Even if the SEC does not succeed in its efforts to enact regulatory reforms in this area, however, perhaps the threat of regulation may encourage more companies to offer some level of transparency voluntarily in order to avoid the onset of a more rigorous regulatory regime.[429]

426. *See, e.g.*, *id.*; Ewens & Malenko, *Board Dynamics*, *supra* note 418 (using Form D filings of 7,201 startups from 2002–2017); Fan, *The Landscape of Startup Corporate Governance*, *supra* note 34, at 339–45 (employing survey and interview methodologies).

427. Allison Herren Lee, *Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy,* U.S. SEC. & EXCH. COMM'N (Oct. 12, 2021), https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12 [https://perma.cc/A5YM-WJST] (noting the dangers of the opacity of the private markets and the need for more disclosure). Prior to Commissioner Lee's speech, academics had proposed several solutions to the lack of transparency in the private markets. *Id.*; *see also Regulating Unicorns*, *supra* note 330. For a thoughtful analysis of the regulatory paradox of the public-private divide in securities law, see Georgiev, *The Breakdown*, *supra* note 13.

428. Fan, *Catching Disruption*, *supra* note 8, at 380.

429. *See, e.g.*, James Fallows Tierney, *Contract Design in the Shadow of Regulation*, 98 NEB. L. REV. 874, 879 (2020) (arguing that contract designers give more generous terms to consumers than required due to anticipatory self-regulation).

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CONCLUSION

Nontraditional investors are here to stay, although the extent to which they are dominant players may wax and wane depending on economic circumstances. They are not tourist investors, nor should they be characterized as such. These investors are now a mainstay along with traditional venture capital firms. Not only are nontraditional investors bringing increased capital and competition, but they are also inserting themselves earlier into the financing cycles of startups which has led to increased valuations. They have differing expectations regarding board seats and the level of involvement in the startups they invest in. They also do not always act within the expected norms of venture capital financings. Due to the changes nontraditional investors are bringing to the venture capital investing landscape, traditional venture capital firms have found themselves at a crossroads. Some have chosen to reimagine the way they do business and have created new legal structures to meet their new investment theses; others have chosen to stay the course and do what they have always done. In the years to come, nontraditional investors will become even more ubiquitous, and traditional venture capital firms may look more similar to some of the nontraditional investors. The public-private divide will likely continue to diminish. All of this will have normative implications for how startup corporate governance evolves during the time when a startup is still a private company—whether this has positive or negative ramifications remains to be seen.

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