Polynomial Ventures

Venture Capital:
If It Ain't Broke, Why Fix It? *Because It's Broke!*

By Steve Valentor

Most venture capital firms operate as exempt reporting advisers (ERAs) under the Investment Adviser Act of 1940 and must conform to certain criteria to avoid registration and the high costs to ensure compliance with federal regulations. In general, ERAs must invest at least 80% of the fund's capital in private portfolio companies, their portfolio companies may not use debt, and their venture capital fund investors have no intermediate redemption rights.

Many would argue that this has been a fine model and has brought the world great companies, such as Intel, Apple, Microsoft, Amazon, Google and Uber.

The thinking is that venture capital fund investors are sophisticated and know that only a small percentage of their assets under management (AUM) should be invested in these potentially high-risk, high-return instruments. They can afford to tie up their investments for a decade or longer and wait for results. Eventually, however, they need to have their original investments and profits returned to them.

This has led to the common structure for most VC funds. They open, raise investments for a few years, invest in portfolio companies, manage them for five years or so, then during the final two years, sell the companies, distribute the proceeds and close the fund.

The first flaw is that those first few years may not be optimal for fundraising. Next, many portfolio companies simply cannot flourish during the subsequent five-year period. Finally, VCs may be forced to liquidate their portfolios based on the calendar, which will likely lower returns.

A better model would be to raise money when investors are eager to invest, buy portfolio companies when their valuations are low and sell them when their valuations are high, but hold onto them when it makes sense – even after an IPO or acquisition.

VCs operating as ERAs cannot do this. Registered investment advisers (RIAs), however, can.

An RIA is an investment adviser that has registered with the Securities and Exchange Commission (SEC) or a state securities regulator.

RIAs have a fiduciary duty to their clients, which means they have a fundamental obligation to provide investment advice that always is in their clients' best interests—even above their own best interests. Compliance is expensive, but many consider this to be the "gold standard" for investment managers. It is also the highest legal standard of care for investors.

RIAs can invest in private companies, public securities, even cryptocurrency technologies; freely use debt to grow portfolios when it makes sense; and offer investors broader and more promising alternative investments.

RIA compliance can be daunting and expensive, and not many VCs are registered. However, many consider it a good idea whose time has arrived. And many investors agree.

It makes good business sense to follow SEC-mandated portfolio management processes, protect against insider trading, safeguard client assets, keep records, prevent and report conflicts of interest, ensure business continuity plans, ensure cybersecurity best practices, develop a permanent evolving staff, follow a published code of ethics, and, most importantly, provide a consistent process for net asset valuation.

RIAs can offer open-ended fund options to their investors and are not limited to the traditional closed-ended funds which have been the only option for investors over the last 70 years. RIA-managed venture capital funds may represent the most progressive and possibly the best alternatives for institutional investors, endowments, pension funds, family offices, and high-net-worth-individuals.

Steve Valentor is a 30-year technology industry veteran who has worked in computer engineering, semiconductor R&D and software development for companies ranging from startups to the Fortune 200. He has held positions from entry level engineer to senior technical management, CEO and board chair. Currently the managing partner of Polynomial Ventures and an adjunct professor at DePaul University, Valentor holds an M.B.A. in finance and a bachelor's degree in math, both from the University of Illinois at Chicago.

Polynomial Ventures invests in early stage technology companies outside of Silicon Valley and Boston. The Chicago-based firm is an emerging, registered investment adviser (RIA) operating an evergreen fund.