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Implication of U.S. Venture Capital Theories for the Korean Venture Ecosystem

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I. INTRODUCTION

Innovation is the driving force of the world economy. The agent of innovation is small and medium-sized enterprise[1] ("SME"), especially the venture

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1 "In general, an SME is defined to be an enterprise employing less than 300 personnel and of varying size, sector and type…As the main component of the Korean economy, SMEs represent 99.8%

business.[2] The venture business[3] can hardly grow independently, even if sufficiently funded. It requires management and marketing assistance as well as other environmental supports. The interrelationship and interaction among market players and their surroundings make the whole venture capital[4] industry an

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of the entire enterprises (3 million SMEs), and 86.5% of the total employment (10.41 million employees).” “Resources” section of BizMatchKorea.com, http://www.bizmatchkorea.com/aboutus/korea_smes.jsp (last visited Feb 2, 2009).

[2] Notable studies have shown that the monopoly power of a big company is not positively related to innovation but rather impedes innovation. Stefan Duffner, *Principal-Agent Problems in Venture Capital Finance*, at 8 (WWZ/Dep’t of Fin., Working Paper No. 11/03, 2003) (citing “Frisch, A. J. (1993): Unternehmensgrösse Und Innovation: Die Schumpeterianische Diskussion Und Ihre Alternativen, Frankfurt am Main, Campus Verlag[,]” 50-130), *available at* http://www.wwz.unibas.ch/finance/publications/papers/PrincAgent.pdf.

> Modern research supports the notion that large established firms have great difficulty managing innovations that fall outside of their previous experience, including *architectural innovations* (Henderson and Clark, 1990), *competency-destroying innovations* (Tushman and Anderson, 1986), and *disruptive technology* that changes the basis for competition in an industry (Christensen, 1997). Established firms may partially overcome these limitations through *ambidextrous organizational structures* (Tushman and O’Reilly, 1997), *radical innovation hubs* (Leifer et al, 2000), and *corporate venturing* programs that emulate venture capital (Chesbrough, 2000).

John Callahan & Steven Muegge, *Venture Capital’s Role in Innovation: Issues, Research and Stakeholder Interests*, *in* THE INTERNATIONAL HANDBOOK ON INNOVATION 641, 642 (Larisa V. Shavinina ed., 2003); *see also* Melissa Goodwin, *Firm Size and R&D; Testing the Schumpeterian Hypothesis*, UAUJE, 1998, at 1, 6 , *available at* www.econ.ilstu.edu/uauje/PDF's/issue1998/Schumpeterian_Hypothesis.pdf (arguing that “the credibility of the Schumpeterian hypothesis is weakened because of the lack of supporting evidence”).

Many studies support the argument that small start-up companies, especially venture start-ups, are the main engine for the future economic development of a country. *See* Duffner, *supra* note 2, at 9 (stating that “empirical studies concerning the effects of the organizational conservatism and indolence suggest that small firms are typically the source for major innovations. . .”); ROGER WYSE, *What the Public Sector Should Know about Venture Capital, in* INTELLECTUAL PROPERTY MANAGEMENT IN HEALTH AND AGRICULTURAL INNOVATION: A HANDBOOK OF BEST PRACTICES 1281, 1281 (Krattiger et al. eds., 2007), *available at* http://www.iphandbook.org/handbook/chPDFs/ch13/ipHandbook-Ch%2013%2003%20Wyse%20Venture%20Capital-A%20Primer.pdf (stating that “[a] growing amount of [biotechnology commercialization] is done by small companies”); GLOBAL INSIGHT, VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL BACKED COMPANIES TO THE U.S. ECONOMY 4 (4th ed., 2007), *available at* http://www.nvca.org/pdf/NVCA_VentureCapital07-2nd.pdf (claiming that “[t]he nation’s venture capital industry plays a paramount role in nourishing the U.S. economy by bringing innovative concepts and business models to life”).

Let alone the academic studies, we know that most industry leading big companies such as Microsoft, FedEx, and Starbucks started as innovative small businesses.

[3] For the definition of venture business, *see infra* notes 19, 21 and accompanying texts.

[4] Venture capital is “high-risk capital that is invested in early-stage companies.” Wyse, *supra* note 2, at 1282. Venture capital investment “is not a loan; it is an equity investment, with the investor owning shares of the company.” *Id*. In this respect, “[v]enture capital can be defined as equity or equity-linked investments in young, privately held companies, where the investor is a financial intermediary who is typically actively as a director, an advisor, or even a manager of the firm.” Samuel Kortum & Josh Lerner, *Does Venture Capital Spur Innovation?*, 1 n.1 (NBER Working Paper No. W6846, 1998), *available at* http://www.hbs.edu/research/facpubs/workingpapers/papers2/9899/99-078.pdf.

For the explanation of the characteristics of venture capital, *see* ANDREW METRICK, VENTURE CAPITAL AND FINANCE OF INNOVATION 3 (2007), *available at* http://papers.ssrn.com/abstract_id=929145.

Venture capital investment takes the legal form of private placement. William Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 898 (2002). “There is accordingly no public database respecting their financial terms and contracting structures.

ecosystem.[5] The effective functioning of the venture capital ecosystem is a key element to successful promotion for venture businesses. A bank-centered financial system cannot generate the cost-effective mechanisms of venture capital investment.[6] The success of a venture business ecosystem lies in incentive and monitoring mechanisms based on private ordering[7] and a virtuous cycle of venture capital facilitated by active stock markets.

Since the 1997 Asian financial crisis, Korean venture businesses have been recognized as an alternative driving force for the nation's economic growth.[8] Due to the government's supportive policies, the Korean venture industry grew rapidly in quantity and size.[9] However, it is doubtful that the governmental policy achieved the substantial development of the venture industry.[10] The Korean policy to promote venture businesses has mainly consisted of direct support and regulation based on the venture certification system. Under the system, the act and rules artificially define venture business and provide capital, tax benefits, and other preferential regulatory treatments to the government-certified venture enterprises.[11]

Actors in the industry, moreover, can be expected to take a proprietary view respecting their transactions' documentation." *Id*.

[5] *See infra* Chapter IV. Subchapter A. Venture Capital Market System as an Ecosystem.

[6] *See* Bernard Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets*: *Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 246 (1998), *available at* http://www.sciencedirect.com/science/article/B6VBX-35X82RY-2/2/a203fc03bb817d3bd30c161ed08feb40 (arguing that the implicit mechanisms of venture capital contract "cannot readily be duplicated in a bank-centered capital market").

[7] "Professor Fuller has defined private ordering as *law* that parties bring into existence by agreement." Danné L. Johnson, *SEC Settlements: Agency Self-Interest or Public Interest*, 12 FORDHAM J. CORP. & FIN. L. 627, 659 n.168 (2007) (emphasis changed) (citing Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 950 n.1 (1979)); *see also* Ronald L. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1069 (2003) (arguing "the keystone of the U.S. venture capital market is private ordering - the contracting structure that developed to manage the extreme uncertainty, information asymmetry, and agency costs that inevitably bedevil early-stage, high-technology financing").

[8] The Asian financial crisis was a good opportunity in disguise for the Korean economy to be restructured. "[A]fter the financial crisis hit Korea in 1997, Korea had swiftly adjusted itself to the Anglo-Saxon economic model based on open market economy, the government's non-intervention policy, maximization of consumer rights and promotion of shareholder capitalism" *Chaebol Attack Anglo-Saxon Economic Model*, THE KOREA TIMES, Oct. 28, 2004. "[T]he government began to realise that they could no longer depend on large multinational firms to fuel the economy, leading them to shift emphasis from big business to small and medium enterprises." Gary Gregory et al., *Korean SMEs in the Wake of the Financial Crisis: Strategies, Constraints, and Performance in a Global Economy*, 13 (Univ. of Wollongong, Dept. of Econ., Working Paper 02-12, 2002), *available at* http://www.uow.edu.au/content/groups/public/@web/@commerce/@econ/documents/doc/uow012131.pdf. Especially, "[f]acing the . . . erosion of competitive advantage in mature-technology products, the Korean government has attempted to encourage the private sector to develope emergent-technology products." Jangwoo Lee, *Challenges of Korean Technology-Based Ventures and Governmental Policies in the Emergent-Technology Sector*, 20 TECHNOVATION 489, (2000), *available at* http://www.venture.co.kr/article/technovation2000.pdf.

[9] The venture capital market in Korea "start[ed] from a negligible base in the early 1990s and almost tripl[ed] between 1998 and 2001." Günseli Baygan, *Venture Capital Policies in Korea*, at 5 (OECD Science, Tech. and Indus. Working Papers 2003/2, 2003), *available at* http://www.sourceoecd.org/10.1787/248000716362; *see also infra* notes 227, 243 and accompanying texts.

[10] *See infra* notes 245-246 and accompanying texts.

[11] *See infra* notes 33-34 and accompanying texts.

Those government-driven policy measures are contradictory to the goal of the Korean venture capital policy: "the expansion of infrastructure for private sector leading venture investment in order to establish a market-based venture ecosystem."[12] The government's direct involvement in the private sector of the venture capital market seriously impaired the incentive and monitoring mechanism among the market players[13] and checked the spontaneous development of the Korean venture business ecosystem.[14]

The government-driven policy increased the negative impact of the burst of the KOSDAQ[15] bubble[16] in 2000 and brought about market players' moral hazard problems[17] by causing the money game and stock price manipulation.[18] As shown

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[12] Small and Medium Business Administration, "벤처캐피탈 선진화 방안" [Plan for the Advancement of Venture Capital], Briefing for Reporters, 2006, p. 1 (translated from Korean to English), *available at* http://www.smba.go.kr/portal/main.board.BoardServlet?id=01AA&seq=1799&cmd=view&func=0.

[13] *See* Christopher Gulinello, *Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience*, 37 GEO. WASH. INT'L L. REV. 845, 847 (2005) (contending that "[g]overnment involvement will be lethal to [the] engineering efforts if it operates to remove the investors' incentives to select and monitor investments").

[14] *See Corporations, Venture Firms Making Efforts to Enhance Ethical Standards*, THE KOREA HERALD, Jan. 31, 2002 (reporting that "[s]ome venture firm CEOs, such as Ahn Chul-soo, head of Ahnlab, a Kosdaq-registered firm specializing in antidotes for computer viruses, criticized the excessive fund support from the government on the grounds it undermines venture companies' spontaneity"), *available at* http://www.koreaherald.co.kr/.

[15] 'KOSDAQ' stands for Korea Association of Securities Dealers Automated Quotation.

> The similarity of the name to 'Nasdaq,' which is an acronym for National Securities Association of Securities Dealers Automated Quotation, gives the impression that the KOSDAQ stock market is similar to the Nasdaq market. This impression is both true and false. . . the KOSDAQ differs from the Nasdaq in that the government plays a much greater role.

Inseok Shin, *Evolution of the KOSDAQ Stock Market: Evaluation and Policy Issues*, 2 (AT10 Research Conference, the Tokyo Club Foundation for Global Studies, 7-8 March 2002), *available at* http://www.tcf.or.jp/data/20020307-08_Inseok_Shin.pdf.

"After amending Article 172 of the Securities and Exchange Act in 1996, the KOSDAQ stock market was created and managed by several separate organizations." THE KOSDAQ MARKET, KOSDAQ FACTBOOK 2003 5 (2004), *available at* http://km.krx.co.kr.

Currently, the KOSDAQ market has been operated by KRX since KSM, KOSDAQ, and the Korea Futures Exchange were consolidated into KRX. KSDA, SECURITIES MARKET IN KOREA 59 (2007), *available at* http://www.ksda.or.kr/UPLOADFILES/Securities%20Market%20in%20Korea%202007%20(KSDA).pdf.

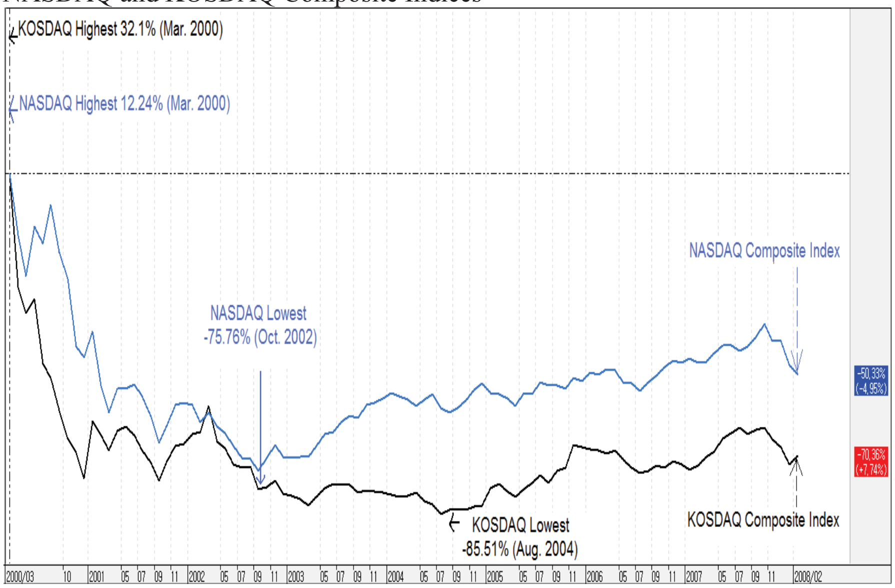
[16] *See* Young-sam Cho, *Report Advises Government to Reduce Support for Start-Ups to Avoid 'Bubble'*, THE KOREA HERALD, April 25, 2000 (reporting the argument that "excessive subsidization of the venture industry might contribute to the development of a venture bubble").

[17] *See KDI Calls for Cut in Government Investment in Venture Firms*, THE KOREA HERALD, July 28, 2000 (reporting the argument that "expanded government investment in venture firms may not only drive out private investments but also lead to moral hazard problems"); Young-sam Cho, *Panel of Experts Portray Gloomy Outlook for Venture Industry*, THE KOREA HERALD, Oct. 30, 2000 (reporting the argument that "the government's measures to boost the Kosdaq by easing conditions for ventures companies to get registered posed large moral hazard problems, increasing the risk to investors").

[18] In 2000, the Korean Development Institute (KDI), "recommended that the government decrease its level of support for venture start-ups, given the risks for a venture *bubble* and *moral hazards* to investors." Cho, *supra* note 16 (emphases changed); *see also Venture Moral Hazards (1): The Money Game*, DIGITAL CHOSUNILBO (English Edition), Dec. 1, 2000, *available at* http://english.chosun.com/w21data/html/news/200011/200011300349.html (last visited June 8, 2008); *Venture Moral Hazards (2): Stock Manipulation*, DIGITAL CHOSUNILBO (English Edition), Dec. 5, 2000, *available at* http://english.chosun.com/w21data/html/news/200012/200012040469.html.

in Figure 1, the burst of the Information-Technology (IT) bubble hit the KOSDAQ market harder than the NASDAQ.

Figure 1: Comparison of Monthly Charts Referring to Declining Rates of NASDAQ and KOSDAQ Composite Indices



Created with Korea Investment & Securities Company's Home Trade System by Kab Lae Kim (2008).

This study comprehensively analyzes both the implicit contract theory and the venture capital cycle theory. Using the U.S. venture capital theories as the framework, this study diagnoses the fundamental problem of the Korean venture policy. Ultimately, this study suggests a market-friendly venture promotion policy based on private ordering among market players and a virtuous cycle of venture capital supported by active IPO markets.

II. OVERVIEW OF VENTURE BUSINESS AND VENTURE CAPITAL

A. The Definition of Venture Business

The term "venture business" is commonly used, but is not uniformly defined.[19] A venture business has the following unique business attributes:

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[19] Venture business is defined slight differently in each part of the world. For example, United States use the terms High Technology Small Firm (HTSF) or New Technology Based Firm (NTBF) as venture business while Japan legally recognizes venture business as firms that invest more than 3% of total sales in Research and Development (R&D).

Tae Kyung Sung et al., *Study on Characteristics of Technology Transfer in Venture Business*, 34th Annual Hawaii International Conference on System Sciences (HICSS-34)-Volume 8, at *2 (2001) (citation omitted), *available at* http://ieeexplore.ieee.org/Xplore/login.jsp?url=/iel5/7255/20032/00927141.pdf?arnumber=927141. The definition of venture business differs according to the economic innovative ideas or technologies, venture entrepreneurs,[20] small scale without large capital outlay, high growth and high risk, and segment or niche marketing. These attributes are opposite to those of a traditional large enterprise: big capital, experienced entrepreneurs, large scale, stable return and low risk, and mass marketing. Based on these attributes, a "venture business" can be defined as a knowledge or technology-based new small enterprise which has the potential to open up a new market with high risk and high return.[21]

Generally, a venture business is known as a high-tech intensive business such as Microsoft or Google. However, the high-technology is not the decisive factor in the definition of venture business. As shown in the cases of FedEx and McDonalds,[22] venture capitalists[23] ("VCs") often invest in traditional business firms if the companies are considered likely to capture a new market[24] and the business risks come with high returns.[25] The deciding factors in the definition of

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system.

> [T]he European definition of venture capital is broader than the American definition." Black & Gilson, *supra* note 2, at 251. "The European Venture Capital Association defines 'venture capital' to include leveraged buyouts and buyins, and replacement of a firm's existing financing. In contrast, leveraged buyout firms in the United States are a distinct industry from venture capital firms; venture capital is also distinct from non-venture private equity financing.

Id. at 267. *See also* Duffner, *supra* note 2, at 2 (stating that "[m]any authors use terms inconsistently or they set different terms to be equal").

[20] The managerial ability of entrepreneurs is essential for the success of the venture start-up. "Indeed, research has shown that venture capitalists rate the quality of the start-up company's management as the single most important consideration in determining whether to support the company." Anderson, *infra* note 38, at 5.

[21] Historically, "[t]he term 'venture business' first surfaced in Japan in the 1960s . . . ." Sunil Mani & Anthony Bartzokas, *Institutional Support for Investment in New Technologies: the Role of Venture Capital Institutions in Developing Countries*, 19 n.5 (Discussion Paper Series 2002-4, 2002), *available at* http://www.intech.unu.edu/publications/discussion-papers/2002-4.pdf.

In Korea, the term "venture business" has become popular since the Act on Special Measures for the Promotion of Venture Businesses was established in 1997. The Korea Chamber of Commerce and Industry, "벤처기업 10 년, 성과와 과제" [Ten Years of Venture Businesses, Achievements and Problems], 2007, p. 1, *available at* http://www.korcham.net/FileWebEDMS/target/20070810004_1.pdf; *see* Act on Special Measures for the Promotion of Venture Businesses ("Venture Promotion Act"), Act No. 9071 (2008).

[22] JOSEPH W. BARTLETT, FUNDAMENTALS OF VENTURE CAPITAL 5-6 (1999).

[23] A venture capitalist is an investor who "search[es] for significantly above-average investment returns through equity ownership and involvement in dynamic (typically start-up and emerging) young companies believed to have experienced management and proprietary or innovative products or services useful in rapidly growing markets." As this definition makes clear, the venture capitalist is more than an investor; rather, he is an owner and participant in the management of the selected company.

Anderson, *infra* note 38, at 4 (citing Daniel H. Case III, *An Overview of Venture Capital*, *in* START-UP COMPANIES: PLANNING, FINANCING, AND OPERATION THE SUCCESSFUL BUSINESS § 6.01[1] (1985)).

Venture capitalists have backed many leading high-technology companies including Sun Microsystems, Netscape, Cisco Systems, Apple Computer, and Genentech. Paul A. Gompers & Joshua Lerner, *What Drives Venture Capital Fundraising?* (1999) (Working Paper, Harvard Univ.), *available at* http://ssrn.com/abstract=57935.

[24] "[W]hether high or low tech, the traditional venture capitalist thrives when the companies in which he invests have an advantage over potential competition in a defined segment of the market, often referred to as a *niche*." BARTLETT, *supra* note 22, at 6 (emphasis changed).

[25] *Cf*. "Therefore, it is not a specific industry that creates a successful venture capital project.

venture business are innovation, venture entrepreneurs, lack of track record and collateral, and a high risk[26] and high return.[27]

In the U.S., the definition of venture business is not of much consequence in either academic or practical sense.[28] A "venture capital backed company" is the more popular and important term in the U.S. venture business industry.[29] It is because the U.S. venture industry has been led by "private equity"[30] investors based on the principle of free market economy.[31] In Korea, the venture industry has been driven by government policies. As a prerequisite to the execution of a venture promotion policy, the statutory definition of venture business is practically important.

In Korea, the Act on Special Measures for the Promotion of Venture Businesses[32] ("Venture Promotion Act") statutorily defines a venture business. Under Article 2-2 of the Act, a venture business firm is defined as an SME which is i) a venture capital-backed company, ii) business with superior technologies by SMBA, or iii) company guaranteed by a technology credit guarantee fund or obtaining loans from government-designated institutions.[33] To receive the benefits under the Venture Promotion Act, a venture business must fall within the statutory definition of venture business as well as meet the procedural requirement of obtaining a certificate of venture business under the Act.[34]

Rather, it is the functional nature of the venture capital contracting mechanism and the alignment of the economic incentives that underlie whether the venture capital contract will be successful." Haksoo Ko & Hyun Young Shin, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT'L L. REV. 457, 473 (1999).

[26] The high risk in connection with venture capital investment is closely related to other characteristics of venture business: innovation and venture entrepreneurs. It is hard to evaluate the technical feasibility and marketability of the *innovation* or to observe the *entrepreneurs*' competence and honesty. *See* Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 54-55 (2002).

[27] *See* Duffner, *supra* note 2, at 6 (explaining that "[t]ypical criteria that distinguish young companies from more mature companies are their small size, missing past, need for equity, negative cash flows, high risks and strong focus on the founder (see Weimerskirch (1999), pp. 6-8)").

[28] *See* Ko & Shin, *supra* note 25, at 471 (stating that "[t]here is no statutory definition of a venture capital company in the United States").

[29] *See generally* GLOBAL INSIGHT, *supra* note 2.

[30] "Private equity . . . refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market." Ho-jin Lee, *The Impact of Private Equity Funds on the Korean M&A Market*, KOREA'S ECONOMY 2007, Feb. 2007, at 24, *available at* http://www.keia.com/Publications/KoreasEconomy/2007/07Ho-Jin.pdf. "Private equity is a broad category that includes leveraged buyout funds, venture funds, real estate funds and other funds that hold illiquid investments, such as many distressed debt, high yield and mezzanine funds." Stephanie R. Breslow & Phyllis A. Schwartz, *Recent Trends in Private Equity Funds*, *in* SEVENTH ANNUAL PRIVATE EQUITY FORUM (2006).

[31] "The American venture capital model usually is centered around a private venture capital firm. However, several options exist, including firms and funds established under the Small Business Investment Act which was passed in 1958. 15 U.S.C. § 631 (1988)." Anderson, *infra* note 38, at 5 n.22 (citing Silvia B. Sagari & Gabriela Guidotti, *Venture Capital: The Lessons from the Developed World for the Developing Markets,* FINANCIAL MARKETS, INSTITUTIONS & INSTRUMENTS No. 2, at 4 (1992)).

[32] The "Act on Special Measures for the Promotion of Venture Businesses" is also called "Special Law to Promote Venture Capital Companies." *See* Ko & Shin, *supra* note 25.

[33] For the detailed requirements to be a "venture business," *see* Venture Promotion Act § 2-2.

[34] For details of the procedure for the certificate of venture business, *see* Venture Promotion Act § 25.

The legislative definition has a dilemma between rigid and flexible definitions of venture business. Venture industries are quickly changing in response to various consumer demands and rapid technical developments.[35] The statutory definition is hard to be updated to cover newly-opening venture businesses. To keep the definition flexible, the Act broadly and abstractly defines venture business and delegates discretion to public officers in providing the detailed standards and certifying whether an SME falls within the definition of venture business.[36] However, administrative discretion can cause many problems relating to incentives, specialty, and the morality of public officers. The government's direct supports and regulations based on the bureaucratic definition of venture business widely and deeply influence the Korean venture industry. So the problems caused by the artificial definition have a substantial negative impact on the whole venture industry in Korea.

The governmental definition of venture business enables the SMEs that fall within the artificial definition to receive preferential support without passing the screening of financial intermediaries. Consequently, incompetent SMEs are allowed to survive in the market, causing the waste of national budget spending and inefficient distribution of economic resources.[37] The direct governmental involvement in and support for venture businesses are based on the government's misunderstanding of the characteristics of the whole venture business ecosystem. As for the venture promotion policy, understanding characteristics of venture capital and its interaction with venture business is of greater consequence than defining venture business.[38]

B. Venture Capital and Staged Financing

Generally, the business assets of a venture start-up company are only its' innovative technology and/or its' business model. Lack of track records in the market and traditional assets that can be used for collateral makes it hard for a venture business to be financed by risk averse debt-financing sources such as banks.[39] Also, in the matter of financing a venture business, banks cannot

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[35] Ko & Shin, *supra* note 25, at 471 (arguing that "a specific and descriptive definition . . . increases the risk of distorting the alignment of economic incentives necessary for successful venture capital contracting").

[36] The Venture Promotion Act delegates the authority to provide detailed requirements for the definition of venture business to the Presidential Decree. Venture Promotion Act § 2-2; Enforcement Decree of Venture Promotion Act § 2-3 (delegating the authority to provide more detailed requirements for the definition of venture business to *Enforcement Rule of Venture Promotion Act* and *Public Notification of the Administrator of Small and Medium Business Administration*).

[37] Jong Soo Choi & Sung Eun Kim, "벤처기업육성에 관한 특별조치법의 문제점에 관한 연구" [A Research on the Problems in the Special Law for Upbringing the Venture business], Journal of Economics Volume 10, Number 2, Korea Economic and Business Association, 2001, p. 196.

[38] *Cf.* Bentley J. Anderson, *Venture Capital and Securities Market Development in Malaysia: The Search for a Functioning Exit Mechanism*, 12 WIS. INT'L L. J. 1, 4 (1993) (arguing that "the best way to provide a working definition of venture capital is to define what a venture capitalist does").

[39] Generally, banks are risk averse. "[T]hey tend to avoid extending loans to companies whose ability to stay solvent and thus pay back their loans remains unproven." David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 364 (2002); *see also* Richard H. Rowe, *The Registered Offering*, *in* FINANCIAL PROJECT FUNDAMENTALS: A GUIDE FOR LAWYERS § 1:2.1 (2006) (stating that "[b]anks may be unwilling or unable to lend to risky,

efficiently overcome the following obstacles caused by the characteristics of a venture business: "high uncertainty," "information asymmetry," "intangible soft assets," and "sensitivity to volatile market conditions." [40] To develop, commercialize, and market innovative ideas or technologies, venture businesses need a specialized form of financing, a venture capital financing, where VCs are willing and able to take and manage the intrinsic risks of the venture business.[41] As well as financial services, venture capital provides "management assistance," "intensive monitoring," and intermediary service as a "reputational capital"[42] to a venture business. Those non-financial services reduce the risks associated with venture capital investment through contractual mechanisms.[43] The economic

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start-up businesses or to lend additional funds to a company with an insufficient equity base"), *available at* WESTLAW, PLIREF-FINP § 1:2.1. Therefore, "[f]inancing is the core problem of young growth companies (see Brettel/Jaugey/Rost (2000), pp. 47-55) slowing their ability to innovate; it can even be called *the entrepreneur's Achilles Heel* (Timmons (1999), p. 411)." Duffner, *supra* note 2, at 12 (emphasis changed).

[40] Callahan & Muegge, *supra* note 2, at 642 (quoting Gompers and Lerner's theory).

> *High uncertainty* is a fundamental trait of innovation that no amount of study or due diligence can entirely eliminate. The future is not only unknown, it is unknowable (Christensen, 1997). *Information asymmetry* refers to the large information gaps possible between innovators and investors. Because of their particular specialized expertise, innovators are likely to have a superior understanding of their innovation, while investors are likely to have a superior understanding of financing. *Intangible soft assets* include patents and trademarks, human capital, and future opportunities. The real value of these assets is difficult to measure; they may have great value to a particular owner, but negligible value to others. The value and liquidity of innovative firms is highly *sensitive to volatile market conditions*. During an economic boom, it may be relatively easy and lucrative to complete an IPO of a promising firm on the public stock markets; in a depressed market, it may be impossible.

Id. at 642-43; *see also* PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 157-58 (2004) (explaining the four obstacles).

The obstacles can be considered as "contractual risks faced by venture capitalists." Utset, *supra* note 26, at 56. High uncertainty includes "contractual risks associated with the uncertainty surrounding the innovation process." *Id.* at 58. Information asymmetry is taken as "informational risks." *Id.* at 56. Intangible soft assets refer to "risks related to the intangible nature of the assets in high-tech start-ups." *Id.* at 57. Sensitive to volatile market conditions means "contractual risks due to the general illiquidity of venture capital investments." *Id*. at 56-59.

[41] However, proponents for "Schumpeterian hypothesis" may not regard venture capital as important for innovation. They believe that the internal financing of large corporations is more efficient for innovation. Gil Avnimelech & Morris Teubal, *Venture Capital Start-Up Co-Evolution and the Emergence & Development of Israel's New High Tech Cluster*, 13 ECON. INNOV. NEW TECHN. 33, 36 (2004), *available at* http://economics.huji.ac.il/facultye/teubal/VC-SU%20coevolution%20EINT%20 2004%20offprint.pdf.

[42]
> [M]anagement assistance to the portfolio company [is] analogous to that provided by a management consulting firm; intensive monitoring of performance [is] reflecting the incentives to monitor arising from equity ownership and the power to act using the venture capitalist's levers of control; and reputational capital . . . is[] the venture capitalist's ability to give the portfolio company credibility with third parties, similar to the role played by other reputational intermediaries such as investment bankers.

Black & Gilson, *supra* note 6, at 252; *see also* Thomas Hellmann & Manju Puri, *The Interaction between Product Market and Financing Strategy: The Role of Venture Capital*, 13 THE REV. OF FIN. STUD. 959, 960 (2000) (explaining that non-financial services include "mentoring, strategic advice, monitoring, certification to outside shareholders, corporate governance, professionalization of the company, and recruitment of senior management").

[43] *See* William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J.

efficiency generated by venture capital cannot be created by bank loan financing.[44] Accordingly, venture capital financing is best suitable for innovative businesses.[45]

A venture start-up has a development life cycle. The start-up's demands for financial support and management assistance change according to the development stage of the company. Responding to the changing financial demands of the start-up, characteristics of private equity investors differ in the degree of risk-taking,[46] the relationship with the venture entrepreneur, and the contents of management assistance. Also, there is a difference in the purpose and use of the invested capital at each stage. The development stage of venture business corresponds with the financing stage of venture capital. Accordingly, the development process of venture business can be categorized into the following stages: Seed Money Stage, Start-Up Stage, Growth Stage, and Pre-Exit Stage.[47] And then, at the exit stage, the private equity investors of the venture start-up liquidate their investment through an IPO, M&A, or backdoor listing.[48]

The outline of the development stages of venture business combined with financing stages of venture capital is shown in the following table:

FIN. ECON. 473, 506 (1990) (arguing that, to manage the investment risks, venture capitalists "become actively involved in managing the companies they fund, in effect functioning as consultants").

[44] *See* Black & Gilson, *supra* note 6, at 246.

[45] *See* Gulinello, *supra* note 13, at 845 (stating that "[i]t is widely agreed that venture capital investment is particularly suited for high-risk, potentially high-return business ventures").

[46] Generally, as the start-up develops, the risks associated with the business diminish.

[47] The stages are categorized by mainly referring to the following two articles: Fredric D. Tannenbaum, *Venture Capital Financing, in* 1 ADVISING SMALL BUSINESSES §§ 15:6 to :9 (2006), *available at* WESTLAW, ADVSB §§ 15:6 to :9; Sahlman, *supra* note 43, at 479 (quoting Plummer's staged venture capital investment theory).

[48] An unlisted company's going public through the backdoor is called a "backdoor listing." A backdoor listing is a financial technique used for a private or unlisted company to be listed on a well-organized and actively-traded stock market, bypassing the normal listing process by combining with a corporation already listed on the market.

According to Edna Carew's financial dictionary, "The Language of Money," the backdoor listing is defined as "[t]he process of achieving stock exchange listing for an enterprise by acquiring an already-listed company structure and injecting new activities into it." ANZ, http://www.anz.com/edna/dictionary.asp?action=content&content=backdoor_listing (last visited June 8, 2008).

Table 1: Financial Sources for a Venture Business Through the Development Stages[49]

Development Stage	Characteristic	Purpose	Financial Status	Financial Source
Seed Money Stage[50]	Company Formation and Initial R&D[51]	Successful Development of Product	Little or No Product and Little or No Revenues	Entrepreneur's Own Money, Relatives, Friends, and Angel Investors[52]
Start-Up Stage[53]	Initial Testing, Licensing, and Marketing of Products	Successful Market Entry	Capital Demands Much More Than Revenues	Venture Capitals,[54] Lenders but No Non-recourse Loan

[49] The table is created by referring mainly to Tannenbaum's "Basic Stages and Structures of a Venture Capital Investment" and Plummer's "The Stages of Venture-Capital Investing." Tannenbaum, *supra* note 47, §§ 15:6 to :9; Sahlman, *supra* note 43, at 479.

[50] The investment risk at this stage is the highest of all the financing stages. Investors at this stage take existing "technology and product risk" and future "marketing and sales risk," while investors at later stages take only "marketing and sales risk." Bill McAleer, *The Various Stages of Investing*, *in* VENTURE CAPITAL EXIT STRATEGIES: LEADING VCS ON EXIT STRATEGIES FOR ENTREPRENEURS & MANAGEMENT TEAMS – INCLUDING M&A, IPOS, & OTHER OPTIONS 83, 85 (2004). In return for taking high risk, investors at the seed stage receive a relatively large proportion of the equity of the invested company. "The early stage is typically the most dilutive stage to the existing owners since the risk to the VC investors is highest. . . ." Tannenbaum, *supra* note 47, § 15:6.

[51] A venture start-up "is focused at [the seed money stage] on researching and developing a product or service, and therefore the viability of the product or assurance that the seed money will sprout fruit are both speculative." Tannenbaum, *supra* note 47, § 15:6.

[52] The angel investor means "[a] financial backer providing venture capital funds for small start-ups or entrepreneurs . . . . Typically, angel investors are friends or family members." Investopedia, Angel Investor http://www.investopedia.com/terms/a/angelinvestor.asp (last visited June 8, 2008).

As of 2000, "angels inject more than $50 billion into young companies each year—more than twice what venture capital firms contribute." Brian C. Bonner & Laura H. Huggins, *"Angel" Investors: Using the Internet in the Private Offering of Securities*, 11-Jun. S.C. LAW 26, 26 (2000) (citing Emory Thomas Jr., *Bands of "Angels" Get Organized*, *available at* http://www.nexsenpruet.com/assets/attachments/53.pdf). The fact shows that "angel investing has been a vital source of capital in" the U.S. *Id.*

[53] The investment risk at this stage is relatively lower than at the seed stage because the technology and product risks have been reduced. Supposing the invested amounts are the same, at this stage, the *venture capital* investors may acquire relatively less proportion of the equity of the invested company than *angel investors*. From the perspective of the venture capital firm, "[t]he cost of capital to the firm . . . will decrease from round to round due to lower risks associated with better forecasts of project earnings." Yahel Giat, Venture Capital Financing with Staged Investment, Agency Conflicts and Asymmetric Beliefs (Dec. 2005) (unpublished Ph.D. dissertation, Georgia Institute of Technology), http://etd.gatech.edu/theses/available/etd-11232005-145909/unrestricted/giat_yahel_200512_phd.pdf.

[54] VCs finance a venture start-up in the form of a staged investment until they exit their investments through an IPO or M&A. *See* RICHARD J. TESTA, *Venture Capital Financing,* STARTING UP AND ADVISING AN EMERGING MASSACHUSETTES BUSINESS (2001), *available at* WESTLAW, SUAEM MA-CLE 7-1 (noting that "[i]n a *staged* investment, the purchase of additional securities at subsequent closings is conditioned upon the accomplishment of certain financial or operational goals . . . as an incentive to management to proceed diligently with the development of its business").

Growth Stage[55]	Market Entry and Business Expansion	Expanding Revenues and Market Share	Generating Revenues or Profits	Add-On Investments by Early Stage Investors or New Venture Capitals
Pre-Exit Stage[56]	Expansion or Acquisitions	Initial Public Offering	Generally Profitable but Requiring Additional Capital	Bridge or Mezzanine[57] Financing

III. LEGAL STRUCTURE OF VENTURE CAPITAL INVESTMENT: BASED ON THE U.S. VENTURE CAPITAL CONTRACT MODEL

A. Contractual Design of Venture Capital Investment

As the term "venture business" is defined above, a venture business is an innovative but risky and immature business without credit and collateral. To transform its innovative ideas into profitable products or services, the venture business should be funded and supported by specialized investors who can provide management assistance[58] and reputation as well as capital.[59] The specialized investors, VCs, possess the expertise and reputation to assist and support their portfolio companies, but not enough cash to invest. The retail or institutional[60] investors with cash need VCs' specialty and experience in evaluating innovative ideas or technologies, selecting portfolio companies, and managing risks associated with uncertainty and information asymmetry. Meeting mutual needs, VCs and outside investors create venture capital funds. And VCs serve as intermediaries between venture businesses and outside investors to balance both

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55 Owing to the start-up's successful market entry and track record in the market, from the second round of the venture capital financing, the risks associated with the venture business are considered to be significantly reduced and the company owner incurs less share dilution. *See* Sahlman, *supra* note 43, at 479.

56 At the pre-exit stage, the venture start-up makes profits. Tannenbaum, *supra* note 47, § 15:8. Also, at this stage, the founders of the portfolio company would like to be free from the monitoring and control of the VCs and the venture capital investors would like to realize the profits of their investments. Therefore, they plan for an IPO, M&A, or other investment exit event.

57 At the pre-IPO stage, "additional funds may be required in the few months prior to an expected IPO." Tannenbaum, *supra* note 47, § 15:8. The term of the investment at this stage is very short because the exit event is coming near. In this respect, the pre-IPO stage is also known as the bridge or mezzanine stage. *See* Sahlman, *supra* note 43, at 479.

58 The management assistance includes providing "management advice and access to better suppliers, lenders, employees, and investment bankers." Gulinello, *supra* note 13, at 846.

59 "Venture capital is therefore a more *hands-on* type of investment than other, more passive investment strategies such as mutual funds." Gregory G. Oehler, *The Wider Implications of "Implicit" Contracts in Venture Capital Partnerships*, 1 N.Y.U.J.L. & BUS. 489, 492 (2005) (emphasis changed).

60 In the U.S., "many limited partners in venture capital partnerships are large pension funds which are covered by the Employee Retirement Income Security Act of 1974 ("ERISA")." *Id.* at 490. "A change in the *prudent investor* rule under the Employee Retirement Income Security Act (ERISA) enabled many large pension funds to funnel capital into venture capital funds." Anderson, *supra* note 38, at 5 n.23 (citing FERNAN IBANEZ, VENTURE CAPITAL AND ENTREPRENEURIAL DEVELOPMENT 1, 16 (1989)) (emphasis changed).

parties' interests.[61] Consequently, the typical legal structure of venture capital investment consists of two contractual relationships: the VC-investor relationship based on the VC partnership agreement and the VC fund-venture business relationship based on the investment contract.[62]

The key players in the venture capital market—outside investors, VCs, and venture entrepreneurs[63]—have different objectives[64] and conflicting interests[65] in a venture capital investment. The conflicting interests[66] of the key players combined with the risky characteristics of the venture business cause major problems associated with venture capital investments: "uncertainty, information asymmetry, and. . .agency costs."[67] The uncertainty concerns business prospects, management quality, and technical uncertainty.[68] The information asymmetry between venture entrepreneurs and investors stems from investors' inability to observe the "intentions and abilities" of venture entrepreneurs and lack of expertise of cutting-edge technologies.[69] The agency costs are caused by moral hazard,[70] adverse selection,[71] and holdup.[72] The key players in a venture capital investment create

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61 Duffner, *supra* note 2, at 89 (asserting that VCs as intermediaries "try to balance the interests of investors for return, stability and liquidity and the interests of investees for long-term finance and flexibility").

62 *See generally* Sahlman, *supra* note 43, at 489-503; Gilson, *supra* note 7, at 1076-92.

As for analyzing the contractual relationships, as Professor D. Gordon Smith pointed out, "because these contracts are not publicly available, analysis of the terms typically used in venture capital contracts usually rests on a description of such contracts in secondary sources." D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 144 (1998).

63 *See* Duffner, *supra* note 2, at 27 (stating that public investors, venture entrepreneurs, and VCs are "three big groups of actors that participate in the financing of young growth companies"). VCs and venture entrepreneurs represent, respectively, venture capital firms and portfolio companies.

64 *See id*. (stating that the "three main groups involved in financing young growth companies have different objectives").

65 *See id*. at 29 (asserting that "[i]t is obvious that there are tensions between the interests of the investors, the intermediaries and the investees").

66 "Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with *conflicting interests*." Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983) (emphasis added).

67 Gilson, *supra* note 7, at 1076.

68 *Id*. at 1076-77.

69 *Id*. at 1077.

70 Moral hazard means the situation where "the agent [that is, the venture entrepreneur,] will intentionally act in a self-interested manner and contrary to the best interests of the principal." Smith, *supra* note 62, at 137. In the moral hazard situation, "the agent (a) uses information not observable by the principal (hidden information) or (b) performs actions not observable by the principal (hidden action) in order to increase his own utility against the principal's best interest." Duffner, *supra* note 2, at 34.

71 Adverse selection means the situation where "one party cannot discriminate between good and bad quality of the other party, i.e. the other party has hidden characteristics." *Id*. Consequently, "the agent will be incapable of acting in the principal's best interests because of the agent's incompetence." Smith, *supra* note 62, at 137.

72 Holdup describes situations in which the agent systematically uses gaps in incomplete

> contracts, in which not every future state is specified, in his favor (*see* Goldberg (1976), pp. 439-441). After the closing of the contract and after specific investments have been made and sunk costs have been incurred by the principal, the agent reveals his previously hidden intentions openly interpreting the fulfillment of his commitments in his favor and forcing the principal into

the contractual relationships in order to solve the problems caused by uncertainty, information asymmetry, and agency costs.[73]

The uncertainty, information asymmetry, and agency problem are interacted. The more uncertain the business environment is, the more problematic the information asymmetry between entrepreneurs and investors becomes. And, the more the information asymmetry grows, the more agency costs increase.[74] Due to the interconnection among those problems, the market players' responses to solve the problems, which are shown as various contractual provisions,[75] are interrelated. One provision that can solve one problem may aggravate another problem.[76] Accordingly, the contractual design to address the intrinsic risks associated with venture capital investment should be comprehensive.[77] Well-designed venture capital contract relationship creates virtuous cycles of venture capital and guarantees venture business success.

In the structure of the venture capital investment, the key players use a check and balance system to minimize business uncertainties and agency costs by utilizing explicit and implicit financial techniques. In this respect, their relationship seems antagonistic. However, the key players share the ultimate goal of a successful investment exit, or to be more specific, a successful IPO.[78] Consequently, their relationship is both conflicting and cooperative.[79]

B. Explicit and Implicit Relationship Between VCs and Outside Investors

To invest in venture businesses, VCs collect investors[80] and establish a

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> renegotiations (*see e.g.* Spremann (1990), pp. 568-570; chapter 4.2).

Duffner, *supra* note 2, at 34.

[73] Gilson, *supra* note 7, at 1077 (explaining that "[t]he organizational and contractual structure of the U.S. venture capital market responds to [the] trio of problems"). Avnimelech & Teubal, *supra* note 41, at 36 (stating that "VC structure and operation thus creates a way to overcome financial and organizational barriers that held back both innovation in large corporations and R&D project investment by traditional financial institutions").

[74] *Cf.* Smith, *supra* note 62, at 157 (stating that "[m]oral hazard and adverse selection are both caused by informational asymmetries").

[75] A venture capital contract contains various provisions to address information asymmetries and agency problems "because entrepreneurs and venture capitalists face multiple market imperfections in their relationships." Zsuzsanna Fluck et al., Venture Capital Contracting: Staged Financing and Syndication of Later-stage Investments, 1 (Research Paper, 2006), *available at* http://www.bi.no/Oslo Files/ccgr/Fluck_Garrison_myers.pdf. For examples of the provisions, see *infra* notes 122-128.

[76] Fluck et al., *supra* note 75, at 1.

[77] *See id.* at 4 (arguing that "combining staged financing with other venture capital clauses can alleviate the hold up problem and improve efficiency").

[78] Smith, *supra* note 62, at 139.

[79] *See id*. (referring the venture capital relationship as a "cooperative relationship"); *id*. at 138 n.14 (contrasting the "pure agency relationship" with the "cooperative relationship" by quoting an article of Jensen and Meckling).

[80]
> The venture capital firm solicits investors by issuing a prospectus detailing the purpose and scope of the fund to be raised and the nature of the investments sought. The prospectus also details the legal form that will govern the relationship between the venture capital firm and the fund participants (i.e., investors).

Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was it Something Lawyers Helped Structure?*, 77 CHI.-KENT L. REV. 211, 216 (2001).

venture investment organization, usually in the form of a limited partnership.[81] The limited partnership is organized "as a pooled fund."[82] As a typical venture capital limited partnership agreement provides, the VCs assume unlimited personal liabilities as general partners ("GPs") and the outside investors are only responsible for the invested amount as limited partners ("LPs").[83] GPs contribute about one percent of the fund's capital but exercise full control over the operation of the VC fund while LPs[84] contribute about ninety nine percent of the capital[85] but have few managerial rights.[86] The concentration of managerial rights

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[81] "In the early 1960s, the first venture capital fund organized as a limited partnership was formed. Since then, the vast majority of funding for venture capital in the United States has derived from funds organized as limited partnerships." Rosenberg, *supra* note 39, at 365.

"Limited-partnership income is not subject to corporate taxation; instead income is taxable to the individual partners. Also, partnerships can distribute securities without triggering immediate recognition of taxable income: the gain or loss on the underlying asset is recognized only when the asset is sold." Sahlman, *supra* note 43, at 489.

> While the predominant form of organization is the limited partnership, in recent years the tax code has allowed the formation of either Limited Liability Partnerships, ("LLPs"), or Limited Liability Companies ("LLCs"), as alternative forms of organization. . . . The advantages and disadvantages of each has [sic] to do with liability, taxation issues and management responsibility.

National Venture Capital Association (NVCA), http://www.nvca.org/def.html (last visited June 8, 2008).

[82] Sahlman, *supra* note 43, at 489.

[83] *Id*. at 489-90.

In real practice, the party of the venture capital limited partnership agreement is not an individual but an LP or LLC. *See* J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 34:14 (2007), *available at* WESTLAW, Partnership Law & Practice § 34:14; *see also* Rosenberg, *supra* note 39, at 366 (stating that "[t]he limited partners who invest in venture capital are often huge pension funds, university endowments and other entities that are in no position to oversee and monitor their investments").

[84] "Despite restrictions on their managerial rights, limited partners are almost always permitted to vote on key issues such as amendment of the limited-partnership agreement, dissolution of the partnership before the termination date, extension of the fund's life, removal of any general partner, and valuation of the portfolio." Sahlman, *supra* note 43, at 490. However, "limited partners have much less power than, for example, the shareholders of a close corporation." Rosenberg, *supra* note 39, at 380. In essence, LPs are "passive investors." Larry E. Ribstein, *Limited Partnerships Revisited*, 67 U. CIN. L. REV. 953, 958 (1999) (emphasizing that "[t]he main feature of the limited partnership historically has been its combination of the general partnership, with powerful owner-managers, and passive corporate-like investors").

[85] The LPs' capital contributions are made over time by responding to capital calls from GPs. The following quotation explains the capital call commitment:

> An investor becomes a limited partner by "subscribing" to one or more shares of the fund at issue. Subscriptions are obtained by agreeing to a capital call commitment. Under a capital call commitment, limited partners are obligated to forward specified amounts of capital whenever the general partners issue a capital call. Funds establish a timetable for regular capital contributions over a designated period of time, typically two years, with contributions being made quarterly. The schedule of regular capital calls is designed to result in the raising of the fund's articulated capital goal.

Bankman & Cole, *supra* note 80, at 216.

[86] Rosenberg, *supra* note 39, at 366; Sahlman, *supra* note 43, at 490; *see also* Gilson, *supra* note 7, at 1088 (arguing that "[o]rganizing the venture capital fund as a limited partnership serves to vest virtually complete control in the GP"); *cf.* Uniform Limited Partnership Act (RULPA) § 302 (2001) (providing that "[a] limited partner does not have the right or the power as a limited partner to act for or bind the limited partnership"); *id.* at § 404(a) (providing that "[e]xcept as otherwise provided…all general partners are liable jointly and severally for all obligations of the limited partnership unless

on GPs helps make the operation of the VC fund economically efficient.[87] However, on the other side of the coin of GPs' exclusive managerial control, LPs' rights to check and monitor GPs' activities are few.[88] GPs' exclusive managerial rights that are far too great compared to their capital contribution can give rise to information asymmetries and agency problems. For example, a GP may have an incentive to invest in unduly higher-risk and higher-return businesses because the expected "twenty percent carried interest" is much greater than the possible loss of a "one percent capital contribution."[89] Even though the GP bears unlimited liability, this does not effectively suppress the incentive for risky behavior on account of the fact that the GP is not inclined to take risks to the extent that the potential liabilities exceed the value of the fund's assets.[90] However, mechanisms based on explicit and implicit contracts between VCs and outside investors address the problems concerning agency costs and information asymmetry.

Restrictive covenants and compensation provisions included in the limited partnership agreement function as sticks and carrots[91] to control GPs' excessive managerial discretion.[92] Restrictive covenants serve to control GPs' opportunistic activities in a negative way. The covenants are divided into three categories: "those relating to the overall management of the fund, the activities of the general partners, and the permissible types of investments."[93] The compensation provisions function to control GPs' opportunistic activities in a positive way. Even though GPs receive two or three percent annual management fees[94] on the initial amount invested, their main income source is twenty percent carried interest on profits.[95] The carried interest compensation scheme reduces problems concerning

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otherwise agreed by the claimant or provided by law").

[87] *See* Gilson, *supra* note 7, at 1088 (stating that "[b]y investing through a financial intermediary, investors secure the benefit of the GP's skill and experience, which help to reduce the level of uncertainty and information asymmetry that must be addressed in the contract governing a portfolio company's investment").

[88] At the cost of few control rights, LPs enjoy the benefits of "limited liability and flow-through taxation status." Rosenberg, *supra* note 39, at 384. "While limited partners can serve on advisory boards that review certain policy issues, if they become involved in the day-to-day management of a venture fund, they risk losing their limited liability." GOMPERS & LERNER, *supra* note 40, at 65. Also, "[t]he need to retain the flow-through taxation status of limited partnerships can impose great restrictions on the ability of the limited partners to protect their investments." Rosenberg, *supra* note 39, at 386.

[89] Gilson, *supra* note 7, at 1088; Rosenberg, *supra* note 39, at 383.

[90] Sahlman, *supra* note 43, at 490; Rosenberg, *supra* note 39, at 385-86.

[91] In this context, sticks and carrots mean monitoring and incentives. As well as for the relationship between VCs and investors, the combination of sticks and carrots are used for the relationship between VCs and entrepreneurs. "The *carrot* of stock options motivates the managers, but they are worried about the *stick* that the venture capitalists wield as monitors." Bankman & Cole, *supra* note 80, at 211. (emphasis changed). Therefore, the incentive and monitoring structure is one of the main characteristics of venture capital contracting. Gilson, *supra* note 7, at 1078.

[92] Rosenberg, *supra* note 39, at 381.

[93] GOMPERS & LERNER, *supra* note 40, at 73.

[94] "The venture capitalists have historically received a 2 percent management fee, but in recent years this fee has gone up to 3 percent." Bankman & Cole, *supra* note 80, at 225.

[95] "In private equity, there is a general rule of *2 and 20* - a 2% yearly management fee (usually paid quarterly) plus a 20% carry." PureVC, VC Primer: Management Fees, http://www.purevc.com/pure_vc/2006/03/vc_primer_manag.html (last visited June 8, 2008); *see also* Gilson, *supra* note 7, at 1089; Sahlman, *supra* note 43, at 491. "The remaining share of any fund investments is held by the limited

agency costs and information asymmetry by aligning GPs' interests with those of LPs.[96] However, the explicit covenants cannot prohibit all of the possible opportunistic activities of GPs because venture investment activities are unpredictable and complicated. The loopholes of explicit contractual provisions are closed by implicit contractual mechanisms.

The venture capital fund has a fixed term[97] and, when the term expires, the realized investment proceeds should be distributed to LPs, the outside investors.[98] Based on the performance and returns of the VC fund, the outside investors can compare the profitability of the venture capital investment with other investments and appraise the competence and dedication of their VCs.[99] Depending on the evaluation after the investment exit,[100] the investors decide whether to invest in the successor funds created by the same VCs.[101] The existence of the investors' post-exit evaluation makes VCs expect that, if their investment performance is successful, their investors will reinvest in successor funds.[102] The shared expectation by VCs and investors, which is based on economically reasonable investment activities, creates an implicit contract where investors reinvest in the successor funds raised by the same VCs in return for the success of their previous investment that is indicated by a successful investment exit.[103] The implicit terms combined with the explicit terms of a fixed investment period[104] serve to prevent VCs from abusing their disproportionate managerial power.

The implicit contract is not enforceable at law but, as a matter of economic

partners on a pro rata share basis." Bankman & Cole, *supra* note 80, at 216.

[96] Gilson, *supra* note 7, at 1089. However, the carried interest compensation can bring about agency problems. An example is as follows:

> [S]uppose that the first investment realized by the venture capital fund yields a $1 million profit after a return to the investors of their $1 million investment. The GP's share of the profit is $200,000. Now suppose that the next investment realized losses of $500,000, leaving cumulative profits from the two investments of $500,000. If the GP keeps all of its first $200,000 distribution, then it ends up having received not twenty percent of the venture capital fund's profits from the two investments, but forty percent ($200,000/ $500,000). This would give the GP an incentive to realize profitable investments before unprofitable investments, even if that meant realizing the profitable investments prematurely.

Id.

[97] The life span of a venture capital fund is usually ten to thirteen years. GOMPERS & LERNER, *supra* note 40, at 14.

[98] Gilson, *supra* note 7, at 1089-90.

[99] Black & Gilson, *supra* note 6, at 256.

[100] As a result of an exit event, the return on an investment can "take the form of cash or stock in the acquiring company or a distribution of stock from the IPO." Thomas J. Fogarty, *Exit Strategies: Making the Best Decision*, *in* VENTURE CAPITAL EXIT STRATEGIES: LEADING VCS ON EXIT STRATEGIES FOR ENTREPRENEURS AND MANAGEMENT TEAMS – INCLUDING M&A, IPOS, & OTHER OPTIONS 35, 36 (2004).

[101] Consequently, "payment of the exit proceeds to capital providers lets the capital providers recycle funds from less successful to more successful venture capital managers." Black & Gilson, *supra* note 6, at 256.

[102] *See id*.

[103] *Id*.; Rosenberg, *supra* note 39, at 396.

[104] In practice, "the implicit/explicit dichotomy presented above oversimplifies the real world. In fact, some elements of the contract over control are explicit, while others are left implicit." Black & Gilson, *supra* note 6, at 264.

reality, is binding on the parties by mechanism of reputation in the venture capital community.[105] If a VC breaches the implicit contract by doing an opportunistic conduct, the VC will see his or her reputation damaged and have trouble in raising successor funds from current and prospective investors.[106] If an investor ignores the implicit contract enforced by the reputational sanction and takes legal action against an unsuccessful VC, the investor will be notoriously known "for being difficult to work with"[107] in the venture investment community and thus have difficulty in joining a profitable fund.[108] Actually, therefore, there are not many legal disputes between VCs and outside investors.[109]

In a venture capital limited partnership agreement, VCs as GPs hold enormous managerial rights,[110] but outside investors as LPs have little ex-ante control over the GPs' discretion[111] and little ex-post legal relief.[112] The reputation market-based implicit mechanism combined with the fund's fixed investment period aligns the interests of VCs and investors[113] and controls their opportunistic behaviors by means of reputational sanctions.[114] The implicit contracts have more influence on the operation of a venture capital limited partnership than the explicit contracts have.[115]

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[105] Oehler, *supra* note 59, at 496-98; Rosenberg, *supra* note 39, at 394-97. Professor Rosenberg argues that "[t]he term *implicit contract* is arguably just a proxy for reputation." Rosenberg, *supra* note 39, at 397 (emphasis changed). Also, he points out that Professors "Black and Gilson are plainly not arguing that either party to a venture capital fund could enforce the implicit contract in court." *Id*. at 397 n.120.

[106] Gilson, *supra* note 7, at 1090; *cf.* Andrea Schertler, *Path Dependencies in Venture Capital Markets*, at 29 (Kiel Working Paper No. 1120, 2002) (arguing that "[v]enture capitalists have to build reputation, i.e., a track record for successfully financing high-technology enterprises, because they have to raise funds from outside investors that initially have little information about the profitability of venture capital investments"), *available at* http://ssrn.com/abstract=318907.

[107] Oehler, *supra* note 59, at 497.

[108] "Therefore, limited partners [who are outside investors] have an incentive to behave well and not get a reputation for being difficult." *Id*. *Cf.* Bankman & Cole, *supra* note 80, at 217 (explaining that it is competitive for outside investors to participate in prestigious VC funds).

[109] *See* Oehler, *supra* note 59, at 495 (stating that "there are no major cases where limited partners have successfully sued general partners for breach of their fiduciary duties"); *cf.* Rosenberg, *supra* note 39, at 390 (explaining that "default fiduciary duties play little role in the relationship between venture capitalists and investors").

[110] Gilson, *supra* note 7, at 1088.

[111] "If limited partners attempt to exercise control over the partnership, they risk losing their status as limited partners and the corresponding beneficial flow-through taxation status." Oehler, *supra* note 59, at 494.

[112] *Id*.

[113] "The two parties['] interests' [sic] are aligned when limited partners give general partners maximum freedom to invest in exchange for the insurance that the general partners will not get paid and may put their reputations as good venture capital fund managers at risk if they do not invest wisely." *Id.* at 498.

[114] Rosenberg, *supra* note 39, at 397; Oehler, *supra* note 59, at 497.

[115] Oehler, *supra* note 59, at 495 (stating that "the implicit contract - rather than the written document - governs the partnership").

C. Explicit and Implicit Relationship Between VC Fund and Venture Business

After raising capital for the VC fund, VCs thoroughly assess the feasibility and marketability of the innovation of a targeting company and evaluate the competitiveness of the management by reviewing business plans that venture start-ups submit.[116] Through the review with "due diligence,"[117] the VC fund selects companies, negotiates the contract terms, and signs the investment contracts with them.[118] The intensive pre-screening by VCs[119] cannot remove the intrinsic risks associated with venture capital investments: "uncertainty," "information asymmetry," and "agency costs."[120] Those problems are monitored and controlled all through the investment period by operation of incentive and control mechanisms based on the contracts between the VC fund and the portfolio company.[121]

The contractual mechanisms to reduce the risks associated with investing in a portfolio company contain staged financing,[122] syndication of investments,[123] disproportionate allocation of control,[124] incentive-based compensation system,[125]

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[116] Anderson, *supra* note 38, at 5.

[117] *Id*.

[118] *Id*. at 6.

[119] *See* Steven N. Kaplan & Per Strömberg, *Venture Capitalists as Principals: Contracting, Screening, and Monitoring*, 91 AM. ECON. REV. 426, 428 (2001) (stating that "VC's expend a great deal of time and effort in evaluating and screening transactions").

[120] Gilson, *supra* note 7, at 1076.

[121] *Id*. at 1078-87.

[122] The staged financing responds to the three major risks associated with investments in venture start-ups. First, through staged financing, venture investors can manage *uncertainties* by having an option to stop follow-on investment. *Id*. at 1078-79. Second, the "[s]taged financing . . . reduces *agency costs* by shifting the decision whether to continue the project from the entrepreneur to the venture capital fund." *Id*. at 1080 (emphasis added). Lastly, the staged financing narrows the information asymmetry between the VC fund and the portfolio company by "the incentive created by staged financing" and "its impact on the credibility of the projections contained in the entrepreneur's business plan." *Id*. at 1080-81 (emphasis added); *see also* Sahlman, *supra* note 43, at 506-07; GOMPERS & LERNER, *supra* note 40, at 171-200.

[123] "Venture capitalists never fully fund an investment alone. They almost always syndicate the investment with other local companies, particularly those that have large funds." Wyse, *supra* note 2, at 1284. "This so-called syndication can either take place at the same round of financing or be sequential, with new partners coming in at later rounds of financing." Catherine Casamatta & Carole Haritchabalet, *Experience, Screening and Syndication in Venture Capital Investments*, 16 J. FIN. INTERMEDIATION 368, 368 (2007). The syndication is intended "to obtain a second opinion about the quality of a particular investment under consideration" ("*selection* hypothesis") or to "add value to a given project" ("*value-added* hypothesis"). James A. Brander et al., *Venture-Capital Syndication: Improved Venture Selection vs. The Value-Added Hypothesis*, 11 J. ECON. & MGMT. STRATEGY 423, 449 (2002); *see also* GOMPERS & LERNER, *supra* note 40, at 255-71.

[124] The disproportionate allocation of control to a VC fund responds to the three major risks associated with venture investments. First, a VC fund having more control than its equity enables the VCs to "deal with *uncertainty* by means of a governance structure: creating a process that will determine the response to an unexpected event." Gilson, *supra* note 7, at 1082 (emphasis added). Second, "disproportionate representation," "negative covenants," and options for further funding, which are provided through the disproportionate allocation, serve to decrease *agency costs*. *Id*. Lastly, "[o]ngoing monitoring by the venture capital fund, made possible by the disproportionate allocation of control, balances" the *information asymmetry* between the VC fund and the portfolio company because the VCs' know-how to monitor increases as the entrpreneurs' know-how to manage grows. *Id*. at 1083.

convertible securities,[126] entrepreneurs' compensation system,[127] and VCs' rights regarding investment exit.[128] As a result of the contracting, a great deal of explicit and implicit control[129] is transferred from the entrepreneur to the VC fund, or to be more exact, VCs.[130] VCs' huge portion of control rights and option to stop further rounds of funding[131] give rise to problems of VCs' moral hazard.[132] Abusing the

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In addition, "the allocation of control serves to reduce *information asymmetry* by providing the entrepreneur the opportunity to signal . . . . her confidence in her own skills." *Id*. (emphasis added).

"The contractual sources of venture capitalist control are (1) the preferred stock purchase agreement, (2) the terms of the preferred stock, (3) the stockholders' agreement, and (4) employment agreements." Utset, *supra* note 26, at 61; *see also* Sahlman, *supra* note 43, at 508-09; GOMPERS & LERNER, *supra* note 40, at 241-54.

[125] The structure of the entrepreneur's compensation responds primarily to agency costs and information asymmetry problems. . . . [T]he portfolio company's compensation structure creates extremely high-powered performance incentives that serve to align the incentives of the portfolio company management and the venture capital fund. . . .

> . . . [T]he intensity of the performance incentives created by the compensation structure gives rise to a corresponding incentive for the venture capital fund to monitor the portfolio company's performance. This monitoring, together with the signaling properties of the entrepreneur's willingness to accept such powerful incentives, also serves to reduce information asymmetries.

Gilson, *supra* note 7, at 1083-84; *see also* Sahlman, *supra* note 43, at 508.

[126] By utilizing convertible securities according to the performance of the portfolio company, the VCs can flexibly deal with business uncertainties. "[I]f the company succeeds, they can convert this senior security into common stock, but if the firm fails or barely becomes profitable, they will receive a priority over the firm's founders for the limited proceeds available for distribution." JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION: CASES AND MATERIALS 22 (9th ed. 2003). In addition, "[A] convertible security is a powerful instrument to mitigate the double moral hazard problem between the entrepreneur and the venture capitalist. . . ." Klaus M. Schmidt, *Convertible Securities and Venture Capital Finance* 2 (CESifo Working Paper Series No. 217, 2001) (emphasis added), *available at* http://ssrn.com/abstract=273642; *see also* George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 316-19 (2001).

[127] "Generally, entrepreneurs are paid a salary that is below market with the expectation that the bulk of their compensation will come from appreciation of their base equity holdings and be supplemented by stock options awarded during the venture." This compensation system aligns the interests of the entrepreneurs with the VCs'. Utset, *supra* note 26, at 63-64.

[128] Venture capital contracts achieve [investment exit] through three principal mechanisms: (1) a registration rights agreement, which usually requires that the venture file a registration statement with the Securities and Exchange Commission in order to effectuate an initial public offering; (2) the venture capitalist's voting control over the company's equity and control over the board of directors; and (3) redemption rights--that is, a "put" that forces the venture to buy back the venture capitalist's preferred stock (of course, this is of little use if there are no assets to pay for the redemption).

Id. at 68.

"If the company is a success, the venture capitalist can steer it towards an IPO or an acquisition. Failures move toward liquidation or redemption." D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 356 (2005). *See generally* Sahlman, *supra* note 43, at 506-513; Gilson, *supra* note 7, at 1078-87; GOMPERS & LERNER, *supra* note 40, at 171-271.

[129] The explicit control includes "disproportionate representation[,] . . .control of the portfolio company's board of directors, and the restriction of the entrepreneur's discretion through the use of negative covenants." Gilson, *supra* note 7, at 1082. The implicit control is exercised by VCs' "decision of whether to fund the portfolio company's next milestone." *Id.*

[130] *Id*. at 1085.

[131] Usually, options to stop further rounds of funding are complemented by rights of first refusal. Sahlman, *supra* note 43, at 507. The rights of first refusal "restrict the entrepreneur's access to other sources of funding[.]" Gilson, *supra* note 7, at 1086.

control rights or options to stop,[133] VCs may engage in opportunistic behaviors that have negative consequence for the entrepreneurs.[134] In addition, the VCs may turn out to be incompetent, bringing about adverse selection problems.[135] The agency problems involved in the relationship between VCs and entrepreneurs are not one-sided as shown in the traditional corporate-shareholder relationship but mutual and reciprocal.[136]

Generally, the explicit terms of a venture capital contract are not enough to solve the problems of agency costs incurred by entrepreneurs.[137] However, VCs' opportunistic behaviors and incompetence are easily observed in the geographically and socially focused venture capital community and surely punished in the reputation market.[138] The evaluation of VCs' characteristics in the reputation market[139] efficiently responds to problems concerning VCs' moral hazard and hold-up[140] and entrepreneurs' adverse selection.[141] A VC is a repeat

[132] "[T]he potential for opportunism arises from the possibility that the venture capitalist will attempt to renegotiate with the entrepreneur at a point in the relationship when the entrepreneur has diminished bargaining power." Smith, *supra* note 62, at 141; *see also* Gilson, *supra* note 7, at 1085-86.

[133] If a VC exercises the option and stops the follow-on investment, the bad influence on the portfolio company will be remarkable. It is "not only because it would deprive the company of a likely source of funds, but also because it would send a no-confidence signal to other investors." Bankman & Cole, *supra* note 80, at 221.

[134] Black & Gilson, *supra* note 6, at 263; Gilson, *supra* note 7, at 1086.

[135] The adverse selection problems resulting in VCs' poor management support will be serious "because the [investment] relationship is ongoing." Smith, *supra* note 62, at 143.

[136] *Id*. at 139.

[137] Professor Smith argues that some "forms of moral hazard — specifically, those associated with [VCs'] opportunism — are not usually addressed by venture capital contracts." *Id*. at 152. Also, he claims that explicit terms do not respond to the "entrepreneur's adverse selection problem" by stating as follows:

> The entrepreneur's only effective contractual protection against adverse selection (which can be combated after entering a venture capital contract only by terminating the relationship) is discretionary stock redemption. Discretionary stock redemption provisions allow entrepreneurs to repurchase the stock sold to venture capitalists at a predetermined price. . . . Indeed, discretionary stock redemption provisions are sufficiently rare in modern venture capital contracts that many venture capitalists claim never to have seen them.
>
> The absence of discretionary stock redemption provisions from most modern venture capital contracts suggests that the cost to the entrepreneur of protecting against adverse selection through contract are [sic] greater than the risks. . . .

Id. at 152-53.

[138] *See* Black & Gilson, *supra* note 6, at 262-63 (explaining that the "reputation market can police this potential for opportunism"). *Cf.* Utset, *supra* note 26, at 112 n.223.

[139] Professor Gilson suggests three requirements for the efficient reputation market. First, the observed party should be a repeat player in the community. Second, the market participants should share common expectations of the observed party's behaviors. Lastly, the participants can observe the party's conformity to the common expectations. Professor Gilson argues that all the requirements are met in the U.S. venture capital market. Gilson, *supra* note 7, at 1086; *see also* Smith, *supra* note 62, at 160.

[140] "The hold up problem arises because staged financing gives disproportionate bargaining power to the incumbent venture capitalist in later stages of investment since an incumbent venture capitalist is potentially better informed about the project than outsiders." Fluck et al., *supra* note 75, at 1.

[141] "For moral hazard, reputational concerns provide incentives to venture capitalists to refrain from opportunistic behavior. With respect to adverse selection, on the other hand, reputation is employed as a sorting device." Smith, *supra* note 62, at 157; *see also* Black & Gilson, *supra* note 6, at 262-63.

player in the small venture capital community.[142] If a VC becomes notorious for opportunism or incompetence, he or she will be punished by having trouble raising successor funds and/or investing in new venture start-ups.[143]

When large corporate control rights are transferred from entrepreneurs to VCs under the investment contract, the entrepreneurs expect to regain the control rights at the time of a successful IPO.[144] The entrepreneurs' expectation of corporate control recovery can be considered a "call option on control,"[145] created under the combination of explicit and implicit contracts between the VCs and entrepreneurs. The call option, exercisable in the event of an IPO, provides entrepreneurs with strong incentives for the success of the portfolio companies.[146] The explicit contracts regarding the recovery of control rights include the "terms of the preferred stock" and the "negative covenants in investors' rights agreements."[147] It is, however, technically impossible that the explicit contracts specify requirements to trigger the exercise of the option because the success or IPO eligibility of a portfolio company can hardly be defined in the explicit terms of contract.[148] The implicit terms of the contract provide that a VC should cooperate for the portfolio company's IPO when an independent underwriter decides that the company is eligible for an IPO, which results in returning corporate control to the entrepreneurs.[149] The implicit terms are enforceable by the mechanism of the reputation market.[150] If the VC unfairly opposes the possible IPO, the news will

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[142] Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match Specific Assets and Minority Oppression in the Close Corporation* 18 (U. Pa., Inst. for L. & Econ., Working Paper No. 265, 1999), *available at* http://search.ssrn.com/sol3/papers.cfm?abstract_id=145529; *see also* Black & Gilson, *supra* note 6, at 254 (arguing that "[t]he venture capital fund's proffer of its reputation to third parties who have dealings with a portfolio company is credible because the fund is a repeat player").

[143] *See* Gilson, *supra* note 7, at 1086-87; Black & Gilson, *supra* note 6, at 263; Smith, *supra* note 62, at 149 (quoting Sahlman, *supra* note 43, at 513).

[144] *See* Gilson, *supra* note 7, at 1083-84.

> The "IPO exit model" is based on the following three assumptions:
>
> (i) the entrepreneur places substantial private value on control over the company she starts; (ii) it is not feasible for an untested entrepreneur to retain control at the time of the initial venture capital financing; and (iii) it is feasible for a successful entrepreneur to reacquire control from the venture capitalist when the venture capitalist exits.

Black & Gilson, *supra* note 6, at 258.

[145] Gilson, *supra* note 7, at 1084.

[146] Black & Gilson, *supra* note 6, at 261.

[147] "The terms of the preferred stock almost universally require conversion into common stock, with the resulting disappearance of special board representation, on a public offering. The negative covenants in investors' rights agreements also typically expire on an IPO." Gilson, *supra* note 7, at 1084-85 (citation omitted).

[148] "[T]he venture capitalist will be willing to cede control only at the time of exit, not before. Yet a mechanical formula cannot ensure that a reputable underwriter will be willing to take the portfolio company public." Black & Gilson, *supra* note 6, at 264 (accordingly, concluding that the timing of entrepreneur's recovery of control rights is "substantially implicit in fact, even if explicit in form" and emphasizing the advantage of the implicit contract in the matter of the control recovery); *see also id*. at 262.

[149] Gilson, *supra* note 7, at 1085.

[150] The implicit contract is enforceable under the following conditions: "(i) whose terms are clear; (ii) whose satisfaction by the entrepreneur is observable; and (iii) whose breach by the venture capital provider would be observable and punished by the market." Black & Gilson, *supra* note 6, at 262. As for the venture capital investment contract, all the conditions are met. The delegation of the authority to

circulate among entrepreneurs and investors in the small venture capital community creating a bad reputation, which will negatively influence the future performance of the VC.[151] As is in the relationship between VCs and outside investors, the implicit contractual structure of the VC fund-venture business relationship is based on the availability of the reputation market and the IPO exit.[152]

D. Characteristics of Mechanisms in Venture Capital Relationships

Professor Gilson's theory on the characteristics of the contractual and organizational mechanisms of the venture capital relationships suggests the following three combinations: strong incentive and monitoring; explicit and implicit contracts; and the VC-investor relationship and the VC fund-venture business relationship.[153]

First, the combination of strong incentive and monitoring in the venture capital relationships is to solve the principal-agent problems, including informational asymmetry and agency costs.[154] The incentive system aligns the interests of key players in the venture capital market, who have different investment objectives.[155] The interest alignment mechanism includes sanctions, such as discharging directors and abandoning follow-on investments, as well as awards, such as carried interests and stock options.[156] The interest alignment responds to moral hazard, adverse selection, and holdup.[157] VCs' monitoring activities incorporate supporting and advising the management in addition to monitoring management's performance and replacing incompetent management.[158] The monitoring measures address the problems of moral hazard and holdup.[159] The incentive structure and the monitoring activities are interactive and interconnected. Accordingly, venture capital contracting and monitoring activities are mutually affected.[160]

Second, the combined utilization of explicit and implicit contracts in the venture capital investment enhances the economic efficiency and responds to the principal-agent problems. The structures of the explicit and implicit contracts are described in the following Figure 2:

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evaluate the company to independent underwriters satisfies the first and second requirements. The existence of the reputation market in the geographically and socially focused venture capital community meets the third requirement. *Id*. at 262-63.

[151] *Id*. at 263.

[152] *See id*. at 259.

[153] Gilson, *supra* note 7, at 1078.

[154] *Id.*

[155] *See* Duffner, *supra* note 2, at 29.

[156] *See id.* at 52 (listing the interest alignment measures: "[p]artly success-dependent remuneration," "[s]anctions, e.g. earn-outs," "[e]ntrepreneur has to provide a collateral," "[u]se of convertible debt," and "[m]ajority share held by the entrepreneur").

[157] *Id*. at 53.

[158] Kaplan & Strömberg, *supra* note 119, at 429; s*ee also* Duffner, *supra* note 2, at 52 (stating that monitoring is "[f]acilitated through management support").

[159] *Id*.

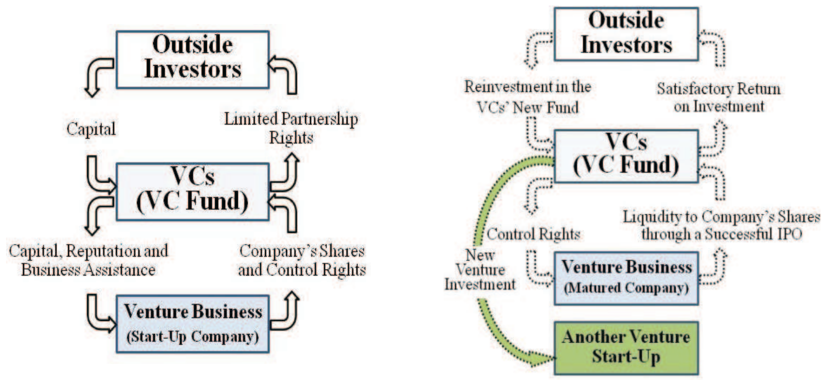
[160] *See id.* at 429-30.

Figure 2: Explicit and Implicit Contracts[161]

Explicit Contractual Relationship

Implicit Contractual Relationship

(In the Event of an Exit through an IPO)



In the relationships among key players in the venture capital market, VCs are given a great deal of corporate control.[162] The VCs' disproportionately allocated control over the VC fund or the portfolio company is not easily controlled by explicit contract provisions[163] and accordingly may cause another type of principal-agent problem.[164] However, the implicit contractual mechanism based on the reputation market discourages VCs from abusing their control.[165] Considering that the venture capital contracts are contingent and the explicit terms cannot provide for all possible situations,[166] the role of implicit contracts is dominant in the venture capital investment.[167]

Third, the VC-investor relationship based on the venture partnership agreement and the VC fund-venture business relationship based on the investment contract are interrelated. The interrelationship minimizes the risks associated with the venture investment and maximizes the efficiency of the venture capital contracting.[168] Professor Gilson emphasizes that the "braiding of the two

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[161] This figure is created by referring to the diagrams of Professors Black and Gilson. *See* Black & Gilson, *supra* note 6, at 256 fig.2 (diagramming the "[i]mplicit and explicit contracts between venture capitalists and outside investors"); *id*. at 260 fig.3 (diagramming the "[i]mplicit and explicit contracts between venture capitalist and entrepreneur").

[162] *See* Gilson, *supra* note 7, at 1081-83 (explaining VCs' control in the VC fund-venture business relationship); *id*. at 1088 (explaining VCs' control in the VC-investor relationship).

[163] *See* Kaplan & Strömberg, *supra* note 119, at 427 (arguing that the disproportionate control structure "suggests that, despite the prevalence of contingent contracting, contracts are inherently incomplete").

[164] *See* Gilson, *supra* note 7, at 1092.

[165] *See id.*; Smith, *supra* note 62, at 158-62; Rosenberg, *supra* note 39, at 394-97 (explaining the reputation-based implicit contract between VCs and outside investors).

[166] *See* Black & Gilson, *supra* note 6, at 263.

[167] *See id*. (arguing that "an implicit contract is likely to have a comparative advantage over an explicit contract").

[168] *See* Gilson, *supra* note 7, at 1091.

contracts"[169] is clearly found in the mechanisms of the reputation market and the investment exit.[170] The VCs' reputation gained in one relationship, whether good or bad, has an impact on the other relationship. If a VC loses his or her reputation by behaving opportunistically in the VC fund-venture business relationship, the VC will have a great difficulty in successor fund raising,[171] where the relationship is between VCs and outside investors.[172] On the contrary, if the VC achieves a reputation among entrepreneurs as a competent and honest financier, the VC gains more access to the other promising venture start-ups and therefore attracts more outside investors.[173] The availability of the reputational sanction through the interaction of the two contracts not only controls the discretion of VCs[174] but also provides them strong incentives for faithful service.

In both the VC-investor relationship and the VC fund-venture business relationship, the investment exit is inevitably scheduled, respectively, by the "fixed term" of the venture partnership agreement and by the VCs' "incentive to realize and then distribute the proceeds of the investment"[175] to outside investors.[176] As well as addressing the problems associated with the venture capital investment, the investment exit enhances the efficiency of the two relationships through the efficient allocation of the economic resources. The more a portfolio company grows gaining reputation and the company's entrepreneurs accumulate management and marketing experiences, the less they need VCs' nonfinancial supports.[177] When the portfolio companies grow and mature enough to be independent of VCs' support, the outside investors want to realize their investments[178] and the entrepreneurs would like to regain the corporate control[179]

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[169] *Id*.

[170] *Id*.

[171] In this context, the fund raising means the "process that venture firms go through in seeking investment commitments from investors." National Venture Capital Association (NVCA), http://www.nvca.org/def.html (last visited June 8, 2008).

[172] Gilson, *supra* note 7, at 1092.

[173] *Id*.

[174] *See supra* note 166 and accompanying text.

[175] Gilson, *supra* note 7, at 1091.

[176] As a venture capital fund has a limited term with an exit plan, VCs start to prepare for the investment exit event from the beginning of the investment. A venture capital expert states that "[a]s venture capitalists, we are analyzing exit strategies from the inception of our involvement with a company." Michael Carus, *Maximizing Exit Opportunities*, *in* VENTURE CAPITAL EXIT STRATEGIES: LEADING VCS ON EXIT STRATEGIES FOR ENTREPRENEURS AND MANAGEMENT TEAMS – INCLUDING M&A, IPOS, & OTHER OPTIONS 10 (2004). The "VC wants to insist at the front end that the portfolio company and its other shareholders sign an agreement which gives the VC control over issues such as the timing of IPO, selection of underwriter, and right to demand additional SEC registrations subsequent to the IPO." K. Thomas Liaw, *Efficient Capital Markets, Venture Capital Investments and Exits, in* APEC SEMINAR ON VENTURE CAPITAL AND START-UP COMPANIES 86 (2003), *available at* http://www.apec.org/apec/enewsletter/aug_vol3/publication.primarycontentparagraph.0002.LinkURL.Download.ver5.1.9.

[177] Black & Gilson, *supra* note 6, at 255.

[178] *See id.* at 256 (pointing out that "venture capital funds have strong incentives to exit from their investments, when feasible, well before the end of the partnership period").

[179] *See* Gilson, *supra* note 7, at 1091 (emphasizing that the entrepreneurs have "an important performance incentive: a call option on control").

from the VCs.[180] By exiting their investments in portfolio companies, venture capital market players can meet their mutual demands and the VCs can provide their services to new venture start-ups. Through this process, the economies of scope are achieved.[181]

Adding to the three characteristics of the mechanisms of the venture capital market, another important characteristic is the cycling of the venture capital investment process. The venture capital investment consists of the following stages: fund-raising, investing, and exiting.[182] After exiting their investments, VCs raise successor funds to invest in new venture start-ups.[183] Given the recurring process of venture capital, it should "be viewed as a cycle."[184] The cyclical characteristic of the venture capital investment is systematically related to exit and reputation markets. Active exit markets are indispensable for the virtuous cycle of venture capital.[185] In the venture capital cycle, VCs acts as repeat players in both the venture capital market[186] and the exit market.[187] The cyclical investment process makes VCs' reputations an essential factor for exiting investments and raising successor funds.[188] Reputation and exit markets are supported by the cycling mechanism of venture capital.[189]

All the phases of the venture capital cycle should be understood as a whole because each phase is interrelated.[190] Each of two major contractual relationships

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[180] Therefore, "[t]he type of exit is an important issue not only for the venture capitalist, but also for the entrepreneur." Armin Schwienbacher, *Innovation and Venture Capital Exits*, at 1 (Working Paper, 2007), *available at* http://ssrn.com/abstract=597441.

[181] Gilson, *supra* note 7, at 1091. The economies of scope mean "[a]n economic theory stating that the average total cost of production decreases as a result of increasing the number of different goods produced." INVESTOPEDIA, Economies of Scope, http://www.investopedia.com/terms/e/economiesofscope.asp (last visited June 8, 2008).

[182] Smith, *supra* note 62, at 136.

[183] GOMPERS & LERNER, *supra* note 40, at 3 (explaining that, after the investment exit, VC "renews itself with the venture capitalist raising additional funds").

[184] *Id*. *See also* Rosenberg, *supra* note 39, at 387 (stating that "[t]wo central characteristics define the venture capital cycle: (1) the cycle takes place in *reasonably well-defined stages*; and (2) the cycle repeats itself once the final stage is completed").

[185] *See* GOMPERS & LERNER, *supra* note 40, at 345 (arguing that the investment exit "is extremely important to the health of the other parts of the cycle").

[186] *See supra* note 143 and accompanying text.

[187] "Typically, VCs are not engaged in only one IPO during their economic lifetime; typically they play a repeated game in the IPO market." Werner Neus & Uwe Walz, *Exit Timing of Venture Capitalists in the Course of an Initial Public Offering*, 14 J. FIN. INTERMEDIATION 253, 259 (2005). Consequently, VC's reputation achieved as a repeat player in the venture capital community plays an important role for a successful investment exit, especially an IPO. *See* Vladimir I. Ivanov et al., IPOs and Venture Capital Reputation 34 (May 30, 2008) (unpublished manuscript, on file with the American Finance Association) (arguing based on empirical evidence that "VC reputation has an economically and statistically significant association with the subsequent investment success of IPO issuers a VC backs"), *available at* http://ssrn.com/abstract=910982.

[188] *See* Rosenberg, *supra* note 39, at 387-88 (arguing that "[t]he cyclical nature of venture capital makes the reputation of the venture capital firm the crucial enforcement mechanism that takes the place of reliance on contractual duties imposed by default rules governing limited partnerships").

[189] *See* Gilson, *supra* note 7, at 1091.

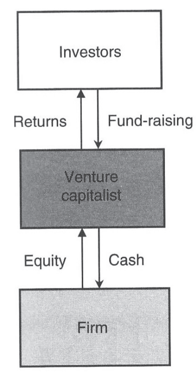
[190] GOMPERS & LERNER, *supra* note 40, at 3.

in a venture capital investment is closely linked to a phase of the cycle.[191] The VC-investor relationship is established during the fund-raising process.[192] In addition, the VC fund-venture business relationship is structured during the investing process.[193] The characteristics of each contractual relationship have direct influences on the behavior of every party of the venture capital contracts,[194] which plays a major role in the venture capital cycle. All the provisions of one of the two contracts mentioned above interact with each other,[195] the two contracts are correlated with each other,[196] and each process of the whole venture capital cycle is interrelated.[197] These interrelationships and interactions enhance the economic efficiency of the venture capital contracts.[198]

To sum up, the risky nature of venture capital investment has made its legal structure unique from other legal structures of conventional financing options.[199] The relationship among the key players in the venture capital market can be understood as a "two-step agency relationship,"[200] where VCs serve as intermediaries between outside investors and venture businesses as investees.[201] The two-step agency relationship consists of the VC-investor relationship and the VC fund-venture business relationship.[202] Those relationships are governed by the terms of explicit and implicit contracts, which contain monitoring and incentive

[191] The dual contractual structure of the venture capital investment can be better understood by seeing the two-step process of capital flow as shown in the figure "Overview of the Venture Capital Process" on the right side, which is excerpted from Gompers & Lerner's "the venture capital cycle." *Id.* at 11.

The figure should be understood as a simplified version of the venture capital process only describing cash and securities flow of the venture capital investment. In practice, however, the venture capital process includes the exchange of venture capitalists' services and company's control rights and other implicit mechanisms. Black & Gilson, *supra* note 6, at 252-64.



[192] *See generally* GOMPERS & LERNER, *supra* note 40, at 23-154.

[193] *See* generally *id.* at 157-342.

[194] GOMPERS & LERNER, *supra* note 40, at 23 (emphasizing that "form influences behavior").

[195] Fluck et al., *supra* note 75, at 1 (claiming that "the *interaction* between different provisions is not yet well understood").

[196] Gilson, *supra* note 7, at 1091-92 (explaining "Braiding of the Venture Capital Fund-Portfolio Company and the Investor-Venture Capital Fund Contracts").

[197] GOMPERS & LERNER, *supra* note 40, at 3-4.

[198] Gilson, *supra* note 7, at 1091.

[199] *See generally* Gilson, *supra* note 7, at 1076-92; Black & Gilson, *supra* note 6, at 252-64.

[200] Duffner, *supra* note 2, at 79.

[201] *Id*.

[202] *Cf*. Smith, *supra* note 62, at 136 (stating that "[a]t each of [venture capital process] stages, two relationships exert powerful, often countervailing, pressure on the parties: the relationship between investors and venture capitalists, and the relationship between venture capitalists and entrepreneurs").

mechanisms.[203] In the venture capital cycle, the mechanisms of one relationship interact with those of the other relationship.[204] The interrelationship of the VC partnership agreement and the company investment agreement help to solve the intrinsic problems associated with the venture capital investment[205] and increase the efficiency of the venture capital market.[206] The theory of Professors Black and Gilson suggests that the economic efficiency of venture capital contracting should be supported by a reputation market and an exit market, especially the active IPO market.[207]

IV. POLICY IMPLICATION OF VENTURE CAPITAL THEORY

A. Venture Capital Market System as an Ecosystem

The venture capital market system is a part of the business system.[208] Some leading scholars draw analogies from a biological ecosystem[209] to describe a business system.[210] Dr. James F. Moore defines the business ecosystem as "[a]n

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[203] Gilson, *supra* note 7, at 1078 (explaining basic characteristics of financial techniques used in the venture capital investment).

[204] *Id*.

[205] *Id*. (arguing that "braiding of the two relationships facilitates the resolution of problems internal to each").

[206] "By braiding [Professor Gilson] mean[s] the fact that the structure of the two contracts are intertwined, each operating to provide an implicit term that supports the other, and thereby *increasing the contractual efficiency* of both." *Id*. (emphasis added).

[207] *See id*. at 1091-92. When an investment exit is conducted through an IPO, the link is created between the venture capital market and the stock market. Black & Gilson, *supra* note 6, at 261; *see also id*. at 245 (stating that an investment exit market serves as "a functional link between private and public equity markets"). The reputation market and the IPO market are interrelated because VCs' reputation has a significant influence on the success of an IPO. Ivanov et al., *supra* note 187, at 37. "Empirical studies suggest that firms backed by well-respected venture capitalists are able to sell shares to the public at higher prices than other firms." Smith, *supra* note 62, at 158 (citing Christopher B. Barry et al., *The Role of Venture Capital in the Creation of Public Companies: Evidence From the Going Public Process*, 27 J. FIN. ECON. 447, 464 (1990); William L. Megginson & Kathleen A. Weiss, *Venture Capitalist Certification in Initial Public Offerings*, 46 J. FIN. 879 (1991)).

[208] *See* Esmond T. Goei, *Venture Capital Ecosystem*, ESMONDSAYS, MB-E, June 1, 2004, at 10 (explaining that "[a]n industry is itself a part of a larger ecosystem that consists of many interrelated parts that may or may not be obvious"), *available at* http://findarticles.com/p/articles/mi_qn6207/is_20040601/ai_n24907657.

[209] It should, however, be pointed out that there are differences between natural and business ecosystems. First of all, in business ecosystems the actors are intelligent and are capable of planning and seeing the future. Second, business ecosystems compete over possible members. Third, business ecosystems are aiming at delivering innovations, where natural ecosystems are aiming at pure survival.

Mirva Peltoniemi & Elisa Vuori, *Business Ecosystem as the New Approach to Complex Adaptive Business Environments,* FRONTIERS OF E-BUSINESS RESEARCH 273 (e-Business Research Center, 2004) (citing MARCO IANSITI & ROY LEVIEN, THE KEYSTONE ADVANTAGE: WHAT THE NEW DYNAMICS OF BUSINESS ECOSYSTEMS MEAN FOR STRATEGY, INNOVATION, AND SUSTAINABILITY 39 (2004)), *available at* http://www.ebrc.fi/kuvat/267-281_04.pdf.

[210] While some advocates for the business ecosystem model argue that the business ecosystem is just an analogy to the biological ecosystem, *see* Peltoniemi & Vuori, *supra* note 209, at 272 (citing JAMES F. MOORE, THE DEATH OF COMPETITION: LEADERSHIP AND STRATEGY IN THE AGE OF BUSINESS ECOSYSTEMS 25-26 (HyperBusiness 1996)), the other proponents for the ecosystem model claim that the two systems "share some fundamental properties." Peltoniemi & Vuori, *supra* note 209, at 279

economic community supported by a foundation of interacting organizations and individuals – the organisms of the business world."[211] The business ecosystem theories have a short history and should be tested and evaluated more.[212] The theories, however, are greatly applicable to the structure and dynamics of the venture capital market.

Venture businesses have innovative ideas and enthusiastic venture entrepreneurs but typically lack management and marketing know-how,[213] track records in the market, and collateral for loans.[214] They need managerial and financial supports from VC funds.[215] In addition to the supports of venture capital, for the promotion of the venture industry, venture businesses should be backed by infrastructures such as "a talent pool of knowledgeable professionals, . . . universities and research institutions, . . . a professional service infrastructure, . . . and customers and lead users of innovation."[216] Therefore, it is much harder for venture businesses to independently survive and grow than for traditional businesses to do so. The incentive and monitoring structure, the explicit and implicit contracts, and the VC market players' relationships are all interrelated and all the players in the market interact through the mechanisms. The interconnection and interaction among venture businesses, private equity investors, and supporting infrastructure can be characterized as a venture business ecosystem.[217] Through

(citing ROGER LEWIN, COMPLEXITY: LIFE AT THE EDGE OF CHAOS 198 (MacMillan Publishing Co. 1999)). A leading scholar who claims the latter's theory asserts that "[b]iological ecosystems and economic systems *are complex adaptive systems and thus follow the same deep laws*." MIRVA PELTONIEMI, BUSINESS ECOSYSTEM: A CONCEPTUAL MODEL OF AN ORGANISATION POPULATION FROM THE PERSPECTIVES OF COMPLEXITY AND EVOLUTION55 (Tampere U. of Tech. 2005) (citing Lewin, *supra* note 210, at 198), *available at* http://www.tut.fi/units/tuta/tita/tip/2004_reports/Peltoniemi_business_ecosystem.pdf.

211 MOORE, *supra* note 210, at 26.

212 *See* Peltoniemi & Vuori, *supra* note 209, at 267.

213 *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 NYU L. REV. 967, 968 (2006) (stating that "many of [venture startups] are founded by entrepreneurs with little business experience").

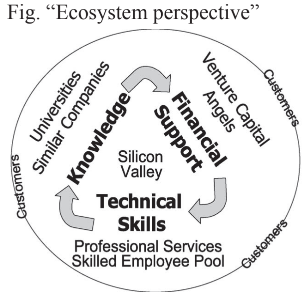
214 Triantis, *supra* note 126, at 309 (stating that start-ups "have too little of a track record to raise capital directly from investors in public markets").

215 *See* Gulinello, *supra* note 13, at 846 (explaining that venture capital develops the high-tech industry by providing venture businesses with comprehensive management and marketing services as well as financial resources).

216 Andrew L. Zacharakis et al., *The Development of Venture Capital-Backed Internet Companies: An Ecosystem Perspective*, 18 J. BUS. VENTURING 217, 220 (2003) (citing Homa Bahrami & Stuart Evans, *Flexible Re-Cycling and High-Technology Entrepreneurship*, 37 CAL. MGMT.. REV. 62, 66-69 (1995)).

The interaction of the components of the Silicon Valley ecosystem is illustrated with the following Figure. Zacharakis et al., *supra* note 216, at 220 Fig.1.

Fig. "Ecosystem perspective"



217 *See* Peltoniemi & Vuori, *supra* note 209, at 273 (stating that "[f]eatures of a business ecosystem include fragmentation, interconnectedness, cooperation and competition" (citing MARCO IANSITI & ROY LEVIEN, THE KEYSTONE ADVANTAGE: WHAT THE NEW DYNAMICS OF BUSINESS ECOSYSTEMS MEAN FOR STRATEGY, INNOVATION, AND SUSTAINABILITY 35 (Harvard Business School Publishing

the conflicting and cooperative interrelationship,[218] the key players of the venture capital market can enhance the market efficiency[219] and coevolve.[220] The ecosystem model is a conceptual tool for understanding the venture industry as a whole and developing a policy to promote venture businesses.

B. Policy Implication

In connection with the government's policy for promoting venture businesses, the theories on venture capital cycle and contract suggest the following:

First, the venture capital system should be considered as an interdependent organic ecosystem and the government's policy should focus on nurturing the ecosystem. The venture capital system is not "a simple, cyclical machine,"[221] but an organic ecosystem which is spontaneous and complicated.[222] Accordingly, it is inefficient for the government to directly control the venture industry through support and regulation.[223] As for engineering the venture capital market, Professor Gilson emphasizes the government's role of "passive investment in a highly incentivized intermediary,"[224] for the spontaneous development of the venture business ecosystem. Professor Gilson highlights the "simultaneous availability" of three key players of the venture capital market: VCs, venture investors, and venture entrepreneurs.[225] He argues as follows:

> The government can act to induce the development of the necessary specialized financial intermediaries and also act to provide, in effect, seed capital, to the new market. That leaves the third factor necessary to solve the venture capital market simultaneity problem - entrepreneurs. Here the hypothesis is simply that the presence of a venture capital framework complete with funding will induce

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Corporation 2008) (2004))).

[218] *See* Peltoniemi, *supra* note 210, at iii (stating that "[a]n organisation population is interconnected through competition and cooperation that can be present simultaneously").

[219] "[T]he ability of the [market] participants to engage in private ordering" is essential for the market efficiency. Gulinello, *supra* note 13, at 847.

[220] *See* MOORE, *supra* note 210, at 82 (stating that "[c]oevolution-in biology and in business-proceeds by both competition and cooperation").

[221] MICHAEL ROTHSCHILD, BIONOMICS: THE INEVITABILITY OF CAPITALISM xiv (Beard Books 1990).

[222] *See id* at xiv (arguing that "economies are spectacularly complex and endlessly adaptable").

[223] "Investment organisations set up without the participation of private sector agents can only promote the *temporary* reduction of capital shortage; they cannot ensure the *longer term development* of the venture capital market, and may even act against it by exerting a crowding-out effect on the private sector." JUDIT KARSAI, CAN THE STATE REPLACE PRIVATE CAPITAL INVESTORS? PUBLIC FINANCING OF VENTURE CAPITAL IN HUNGARY 13 (Inst. Of Econ. Hugarian Acad. of Sci. 2004), *available at* http://www.econ.core.hu/doc/dp/dp/mtdp0409.pdf. *See also* ERNST & YOUNG, TRANSITION: GLOBAL VENTURE CAPITAL INSIGHTS REPORT 5 (Ernst & Young Global Ltd 2006) (pointing out the problems of the "[l]arge degree of control exercised by the central government in the venture ecosystem, resulting in disincentives for both entrepreneurs and investors"), *available at* http://www.ey.com/global/assets.nsf/International/SGM_-_VC_-_Insight_-_May_2006/$file/EY_SGM_VC_Insight_Report_May2006.pdf.

[224] Gilson, *supra* note 7, at 1102.

[225] *Id*. at 1093.

entrepreneurs to reveal themselves.[226]

Professor Gilson's "simultaneity" theory may lead to the idea that, in order to promote venture businesses efficiently, the government should take the venture industry as an *organic whole* and "nurtur[e] the natural process of [the venture industry's] growth."[227]

Second, the venture capital contract theory indicates that the efficient venture capital market is established by private ordering,[228] which is enforced by reputational sanction.[229] The success of the venture industry depends on the efficiency of the venture capital market, which is generated by market players' efforts "to reduce their transaction costs"[230] by private ordering. As Professor Troy A. Paredes argues, the preconditions for the efficient private ordering are as follows: the parties in the market should 1) be sophisticated enough to comprehend the issues to be negotiated, 2) transact at low cost, and 3) be repeat players.[231] In a developing economy, however, the capital market condition does not satisfy the requirements for private ordering. Only the government, not the private sector, has the incentive to establish the infrastructural preconditions for successful private ordering.[232] The government can promote sophisticated negotiations among market participants by supporting educational institutions for venture capital experts, especially VCs as intermediaries between venture businesses and investors.[233] The experience and sophistication of the venture capital experts can

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[226] *Id*. at 1094.

[227] ROTHSCHILD, *supra* note 221, at xv (arguing that the government should be "the astute cultivator of society's economic ecosystem").

[228] *See supra* note 7 and accompanying text. *Cf.* Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 TENN. L. REV. 79, 154 (1997) (arguing that "[b]y taking advantage of holes in the regulatory framework and by entering into creative agreements with management of the companies in which they invest, venture capital companies are able to gain potential, if not actual, control over their portfolio companies").

[229] *See* Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2328 (2004) (stating that "[t]he typical enforcement mechanism associated with private ordering is the reputation mechanism, in which a merchant community punishes parties in breach of contract by denying them future business").

[230] Gulinello, *supra* note 13, at 847.

[231] Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM & MARY L. REV. 1055, 1109 (2004).

Similarly but from different perspectives, as Professor Sanford J. Grossman suggested, the voluntary disclosure system based on private contracts should meet the following conditions: "1) investors know that firms have that information (for example, they know it has collected the level of revenues for that year); 2) firms cannot lie (albeit they can refuse to disclose their information); 3) disclosure is costless." *See* Luigi Zingales, *The Costs and Benefits of Financial Market Regulation* 18 (ECGI - Law, Working Paper No. 21/2004, 2004) (citing Sanford J. Grossman, *The Information Roles of Warranties and Private Disclosure about Product Quality*, 24 J.L. & ECON. 461 (1981)), *available at* http://ssrn.com/abstract=536682.

[232] *See* Gilson, *supra* note 7, at 1094 (stating that "[n]o institution other than the government has the right incentive to invest in the public good that results from establishing a venture capital market").

[233] *See* Paredes, *supra* note 231, at 1110-12 (emphasizing the role of intermediaries like "transaction cost engineers") (citing Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 255 (1984)).

Cf. Hoe Hoon Chung, *Lessons from the Korean Venture Industry Development*, 30 (World Bank, Innovation Policy Work Background Paper, 2004) (stating that "in Korea the venture capitals only estimate the business and invest but don't actually have the capacity to support the business or have facilitate the standardization of private contracting and this standardization decreases transaction costs.[234] The government should not interfere with the incentive and monitoring mechanisms of venture capital contracting because it is likely to restrict private ordering and harm market efficiency.[235]

Lastly and in line with the above-mentioned argument, it should be emphasized that active exit markets are an essential requirement for the efficient venture business ecosystem. Through the exit route, venture capital can circulate actively.[236] The active venture capital cycle makes the market participants continuing players.[237] The continuing playing of market players creates the reputation market[238] and enables the implicit mechanisms of the venture capital investment.[239] Consequently, the existence of active investment exit routes is a prerequisite to a prosperous venture capital market.[240] For developing countries, the establishment of active exit markets is important and challenging.[241] Due to small and undiversified exit routes, many countries have been unsuccessful in the introduction of the U.S. model of the venture capital market.[242] To promote a venture industry, therefore, the government's policy should focus on the establishment of the infrastructure for the exit channels.[243]

V. KOREAN POLICIES FOR PROMOTION OF VENTURE BUSINESSES

A. Overview of Venture Policies in Korea

The Korean economy has rapidly developed since the early 1960s and now faces two ways: growing into an advanced country or remaining as a developing country.[244] Now is the time for the Korean economy to overcome the challenges

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enough experience in it"), *available at* http://info.worldbank.org/etools/docs/library/109280/KoreaVenture_final.pdf.

[234] *See* Paredes, *supra* note 231, at 1113-14.

[235] *See* Gulinello, *supra* note 13, at 860 (stating that "any regulatory attempt to limit [market participants'] ability to engage in such private ordering could adversely affect the efficiency and prospects of the venture capital market").

[236] *See* Wei Luo, The Exit of Venture Capital and Earnings Management in Newly-Public Firms, at 3 n.1 (Presentation Paper at 2005 FMA Annual Meeting Program, Session No. 232, 2005), *available at* http://www.fma.org/Chicago/ChicagoProgram.htm (explaining the venture capital cycle).

[237] *See supra* notes 143 and 188.

[238] *See supra* note 140 (defining the repeat playing as one of the requirements for the efficient reputation market).

[239] *See* Black & Gilson, *supra* note 6, at 245 (arguing that "[t]he implicit contract over future control . . . is permitted by the availability of exit through an IPO").

[240] *Id*.

[241] *See* Anderson, *supra* note 38, at 2 (arguing that "[t]he absence of viable exit mechanisms has been identified as one explanation for the difficulties developing countries have encountered in creating a venture capital industry").

[242] Black & Gilson, *supra* note 6, at 245.

[243] *See* Gulinello, *supra* note 13, at 878 (arguing that the Taiwanese "government efforts to stabilize the domestic securities market and liberalize listing for emerging and entrepreneurial companies attracted private-sector investment in the venture capital market by creating a potential avenue for investment exit").

[244] Korea rose from the ashes of the [Korean] war, and, in 30-40 years, rose from being

to joining the ranks of the developed countries.[245] As Korea is not blessed with natural resources, the Korean economy suffers from the recent global trend of high raw material prices.[246] Also, high labor costs restrict the development of traditional businesses in Korea.[247] The Korean economy's strength lies in "large investment in R&D and education."[248] Consequently, knowledge-based small venture businesses, as agents of innovation, should serve as a major engine for future economic growth in Korea.[249] In this respect, the Korean government's policy to promote the venture industry aims not only to develop the hi-tech SME sector but to restructure the Korean economy into a "knowledge-based"[250] one.[251]

> one of the world's poorest countries to entering the ranks of the OECD - the group of the world's richest nations. For example, per capita income increased 157 times, from $67 in 1953 to $10,543 in 1996. Korea was the envy of much of the world and a role model to underdeveloped countries.

Dong-gull Lee, *Toward a Post-Crisis Vision for Financial Sector*, THE KOREA HERALD, March 31, 2008; *see also* Marcus Noland, *South Korea's Experience with International Capital Flows* 4-6 (Inst. for Int'l Econ., Working Paper No. 05-4, 2005) (explaining the historical context of the Korean economy), *available at* http://ssrn.com/abstract=759646; Randall Jones, *Creating a Knowledge-Based Economy in Korea*, THE KOREA HERALD, March 11, 2008 (stating that "[r]apid economic development has increased Korea's per capita income from only 20 percent of the OECD average in 1970 to nearly 70 percent by 2006, boosting Korea to 23rd among the 30 OECD countries"); THE WORLD BANK, KOREA AS A KNOWLEDGE ECONOMY: EVOLUTIONARY PROCESS AND LESSONS LEARNED 1 (World Bank 2006), *available at* http://web.worldbank.org/WBSITE/EXTERNAL/WBI/WBIPROGRAMS/KFDLP/0,,contentMDK:20997709~isCURL:Y~menuPK:1727232~pagePK:64156158~piPK:64152884~theSitePK:461198,00.html.

[245] Some challenges are the results of the side effects of the government-driven policy to rapidly develop the Korean economy. One important side effect caused by the policy is "a dualistic economy divided between a highly competitive, export-oriented manufacturing sector and a much less dynamic domestic demand oriented sector." Jones, *supra* note 244. For an explanation of "challenges to Korea's future development," *see* CARL J. DAHLMAN & THOMAS ANDERSSON, KOREA AND THE KNOWLEDGE-BASED ECONOMY: MAKING THE TRANSITION 28-31(World Bank Publications, 2001); The World Bank, Overview, *supra* note 244, at 31-33 (explaining challenges for a knowledge economy).

[246] *See* Soh-jung Yoo, *Raw Materials Prices Continue to Surge*, THE KOREA HERALD, Jan. 15, 2008; *The Rising Cost of Nature*, THE KOREA HERALD, Sep. 22, 2007 (reporting that "[a] fundamental global trend nowadays is growing natural resource scarcity").

[247] *Cf*. Jones, *supra* note 244 (stating that "[d]espite growing competition, Korea has considerable scope to raise labor productivity, which was 60 percent below the U.S. level in 2006"); Ji-hyun Cho, *President Warns against Hardline Labor Unions*, THE KOREA HERALD, March 14, 2008 (stating that "Foreign-invested companies here listed high labor costs as the biggest obstacle in establishing or expanding businesses in Korea, according to a recent poll conducted by the Korea Chamber of Commerce and Industry"); *see* Gilson, *supra* note 7, at 1068 (arguing that "[a]t a time when developing countries are increasingly losing manufacturing jobs to low wage countries, and when low wage countries seek industries that depend on more than just cheap labor, creating a venture capital market has become the holy grail of economic development").

[248] Jones, *supra* note 244; *see also* Chung, *supra* note 233, at 2 (arguing that "the continuous investment of Korean society in education and technology development during the past 30 years was another key factor that accelerated the growth of startup firms and their development"); The World Bank, Overview, *supra* note 244, at 8-19.

[249] *See* Lee, *supra* note 8, at 489 (stating that "[s]mall firms have played an important role in technological innovation and economic growth in developed countries").

[250] According to the OECD definition, knowledge-based economies mean "economies which are directly based on the production, distribution and use of knowledge and information." DAHLMAN & ANDERSSON, *supra* note 245, at 31. For a detailed explanation of the "concept of a knowledge-based economy," *see id*. at 31-32; *see also* Jones, *supra* note 244 (maintaining that "[c]reating a knowledge-based economy is key to sustaining high growth rates in Korea and boosting income levels to those in the leading OECD countries").

The history of venture policies in Korea can be generally divided into the following three eras: "Quickening Era," "Infrastructure Expansion Era," and "Adjustment Era."[252] The details of each era are shown in the following Figure 3.

Figure 3: History of Venture Policies in Korea[253]

Before 1997: Era of Quickening Venture Industry

1. Enactment of the Support for Small and Medium Enterprise Establishment Act (1986)
2. Enactment of the Financial Assistance to New Technology Business Act (1986)
3. Establishment of the KOSDAQ Market (1996)

→ The advent of the first generation of venture businesses owing to the construction of the legal infrastructure

1997-2001 : Era of Promotion for Venture Business Inauguration and Expansion of Venture Infrastructure

1. Establishment of the Act on Special Measures for the Promotion of Venture Businesses (1997)
2. Preferential Tax Policy for Venture Businesses (1998)
3. Activation Plan for the KOSDAQ Market (1998)
4. Investment Support for Start-Up Investment Company (1999)

→ Explosive Growth of Venture Industry along with Expansion of IT Industry

After 2002 : Era of Adjustment to Ensure Substantiality of Venture Businesses

1. Reinforcement of the Venture business certification system (2002)
2. Improvement of Transparency of Venture Capital (2003)
3. Strengthening of the KOSDAQ's Delisting Criteria (2003)
4. Measure for the Activation of Venture Businesses (2004)*
5. Plan for the Advancement of Venture Capital (2006)*
6. Revision of the Act on Special Measures for the Promotion of Venture Businesses (2007)*

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[251] Chung, *supra* note 233, at 2.

[252] MINISTRY OF FINANCE AND ECONOMY ET AL., 벤처기업 활성화대책 [MEASURE FOR THE ACTIVATION OF VENTURE BUSINESSES], Agenda of Economy-Related Ministers' Meeting 3 (2004), *available at* http://mofe.go.kr/division/br_pc/br_pc_03.php?action=view&field=&keyword=&page=52&t_code=500&no=59195.

[253] This figure is a translated version of a chart of "Development of Venture Policies" in "Measure for the Activation of Venture Businesses." *Id*. Star marked parts are added to the original chart.

(The expiration date of the Act became extended from Dec. 31, 2007 to Dec. 31, 2017)
→ Assurance of Transparency and Guidance for Soft Landing of Venture Industry

Since the enactment of the Support for Small and Medium Enterprise Establishment Act in 1986,[254] the Korean government has promoted venture businesses in various direct ways, such as providing direct financing,[255] giving tax benefits,[256] and lifting regulatory restrictions.[257] During the Asian financial crisis in 1997-1998,[258] the Korean government strongly acknowledged the venture businesses as a driving force for the revival of the Korean economy.[259] Then, the government reinforced the policies for encouraging high-tech venture start-ups based on new legislations.[260] The government-driven policy primarily consisted of the government's direct support and regulation of venture businesses.[261] Owing to

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[254] Not until 1986…did Korea provide the institutional infrastructure for the venture capital industry. In 1986 Korea enacted several laws related to venture capital, including the Law to Promote Small and Medium Size Companies and the Law to Assist the Financing of New Technology Ventures. After these laws were enacted, the industry grew rather quickly.

Ko & Shin, *supra* note 25, at 468.

[255] *See* Suk-young Lee, *Korea's Policy Measures on SMEs and the Changing Environment - Korea's Experience in Fostering Venture Enterprises*, at 4 (Presentation Paper at APEC 9th Meeting of Ministers Responsible for SMEs, 2002), *available at* http://www.apec.org/apec/documents_reports/small_medium_enterprises_ministerial_meetings/2002.MedialibDownload.v1.html?url=/etc/medialib/apec_media_library/downloads/ministerial/sectoral/smemm/2002.Par.0009.File.v1.1.

[256] *See* Ko & Shin, *supra* note 25, at 458 (stating that "the Korean government is playing a more active role in its venture capital market by providing tax-subsidy incentives for eligible companies").

[257] *See* Lee, supra note 255, at 3.

[258] *See* The World Bank, *supra* note 244, at 7 (pointing out that excessive governmental intervention and weak private financial sectors caused the financial crisis).

[259] "Since the Asian financial crisis in late 1997, venture businesses have been praised as a de facto alternative to rebound the economy." *Venture Cos. Chart Ethics Codes Amid Mounting Scandals*, THE KOREA TIMES, January 18, 2002. Before the Asian financial crisis, "[t]here had been several initiatives by previous Korean governments to promote small and medium-sized enterprises (SMEs). However, the support for SMEs through the subsidisation of 'venture business' and of venture capital by the Kim Dae-Jung government after the financial crisis is unprecedented in several respects." JANG-SUP SHIN & HA-JOON CHANG, RESTRUCTURING 'KOREA, INC.': FINANCIAL CRISIS, CORPORATE REFORM, AND INSTITUTIONAL TRANSITION 109 (ROUTLEDGECURZON STUDIES IN THE GROWTH ECONOMIES IN ASIA, 2003).

[260] As well as the Venture Promotion Act, the new legislations include "the Law for the Assistance of Small and Medium-sized Enterprises Start-up (LASMES), the Law for the Financial Assistance to New Technology Enterprises (LFANTE), the Finance Business Specialised in Lending Law (FBSLL) and the Law on Limitation of Special Tax Treatment (LLSTT)." Young-Cheol Jeong, Korea Venture Business, Venture Capital and KOSDAQ (Woo, Yun, Kang, Jeong & Han, 2001), *available at* http://www.altassets.com/casefor/countries/2001/nz2846.php.

[261] [A]n unprecedented amount of public money was poured into supporting venture business. The government launched the 100-billion-won Korea Venture Investment Fund with co-investment by foreign investors in 1999. Public funds spent in supporting the establishment of new SMEs, mainly in the form of investing in or lending to venture capital and venture companies, increased by 36 times from 34.4 billion won ($28.7 million) in 1997 to 1,237 billion won ($1,030.8 million) in 1999 (SMBA website).

the government's active involvement, the venture industry in Korea had grown fast in quantity and size until 2001.[262] However, the Korean government failed to change the economic structure of Korea from a conglomerate-oriented structure to a venture SME-based one.[263] In addition, the government-led policy caused many side effects such as "inefficient allocation of economic resources,"[264] "moral hazards of venture businesses,"[265] and "inefficient market entry and exit."[266] These side effects, combined with the IT boom that was artificially promoted by the government, exacerbated the dot.com bubble until the second half of 2000.[267] As a result, when the world-wide IT bubble burst in mid-2000, the KOSDAQ market collapsed[268] on a much larger scale than the NASDAQ market did.[269] Thereafter, a series of financial scandals involving venture businessmen broke out.[270] The financial scandals undermined the market integrity and investor confidence in the KOSDAQ. Consequently, the KOSDAQ market became sluggish until the middle of 2004.[271]

Experiencing the side effects of the government-driven policy such as

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SHIN & CHANG, *supra* note 259, at 109.

[262] "The number of venture businesses in Korea rose above 10 thousands in 2001 . . . . The KOSDAQ Composite Index hit the historic high by increasing 3.4 times in a year in 2000 . . . . The number of centers for business incubation had increased from 30 centers in 1998 to 293 centers in 2002." YOON-CHUL LIM ET AL., "새로운 기술집약적 중소기업(벤처) 정책 발굴 연구" [A PERSPECTIVE OF THE POLICY DEVELOPMENT FOR TECHNOLOGY BASED FIRM(VENTURE FIRM] 21 (Science and Technology Policy Institute) (translated from Korean to English), *available at* http://www.stepi.re.kr/ResearchPub/Fulltext/F05-01.pdf.

[263] "The share of SMEs' contribution to manufacturing production increased only by 1 per cent from 46.3 per cent in 1997 to 47.3 per cent in 2000 (SMBA website). The Korean economy is still dominated by large companies, as it has always been for the last few decades." SHIN & CHANG, *supra* note 259, at 111.

[264] Ministry of Finance and Economy et al., *supra* note 252, at 2 (translated from Korean to English).

[265] *Id*. (translated from Korean to English).

[266] *Id*. (translated from Korean to English).

[267] SHIN & CHANG, *supra* note 259, at 111 (stating that "the attempt to achieve [the establishment of the vibrant SME sector] overnight led to a *huge bubble* in the KOSDAQ market") (emphasis added).

[268] On March 10, 2000, the electronic board displaying stock prices at the Kosdaq market was filled with red figures, meaning that the prices rose from the previous day. The market closed the day at 2834.4 points, a record high. On the following Monday, however, the Kosdaq index dropped by 39 points, showing a sign of unease. The unease drove small investors into a state of panic.

> On March 17, the stock price index shed 159 points from the previous day. On March 20, the price index plummeted further by 187 points.
>
> The Kosdaq index continued to take a beating, and eventually came to at 525.80, following an endless series of downturns.
>
> And so the bubble had burst. The sharp decline in the Kosdaq index forced venture businesses into a corner.

Moon-sool Cho, *Venture Businesses Nosedive as Bubble Bursts*, THE KOREA HERALD, March 2, 2007.

[269] *See supra* Figure 1 at 108.

[270] "At the time, venture businessmen were regarded as conmen in the market. Even institutional investors and venture investment companies, not to mention angel investors, turned their back on the [venture investment] market." Cho, *supra* note 268.

[271] After the IT bubble was bursted in early 2000, the KOSDAQ market index "crashed to a [historical] low of 324.71 on August 4, 2004." *S Korea's KOSDAQ Market to Celebrate 10th Anniversary on July 1*, ASIA PULSE, June 20, 2006.

"failure in substantial and profitable growth, formalism in the support of technology innovation and commercialization, and lack of policy diversification,"[272] the Korean government seemed to realize that the existing policy focusing on the numerical or quantitative growth should be changed into a market-oriented policy for the substantial growth of venture businesses. Since 2002, the Korean government has modified the venture business policy to guarantee the sustainable development of venture industry.[273] As for important new policies, the government announced "Measure for the Activation of Venture Businesses"[274] in 2004 and "Plan for the Advancement of Venture Capital"[275] in 2006, which are intended for nurturing the venture business ecosystem.[276] The new policy aimed to establish an infrastructure suitable for the characteristics of venture businesses and enhance the capacity of the capital market.[277] After the new policy was adopted, the number of venture enterprises and the amount of venture capital investment began increasing and the KOSDAQ composite index started to rise.[278]

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[272] Lim et al., *supra* note 262, at 1.

[273] In 2002 and 2003, the Korean government announced two major plans: "Plan for Reforming the Venture Capital System to Activate the Venture Investment Market" (2002) and "Plan for Promoting M&As of Venture Businesses" (2003).

The major contents of the former plan are "creation of the secondary market to accelerate venture investment exit," "improvement of government's investment for venture businesses [indirect investment through] fund of funds," and "introduction of new system of venture capital taking the form of limited liability company." *Id*. at 9 (translated from Korean to English).

The major contents of the latter plan include "removal of obstacles to M&As and simplification of the process," "creation of environment where it is easy to swap stocks," "improvement of role and function of existing M&A funds," and "strengthening functions of intermediary and evaluation of venture businesses for M&As." *Id*. at 10 (translated from Korean to English).

[274] Ministry of Finance and Economy et al., *supra* note 252. The "Measure for the Activation of Venture Businesses" is a detailed plan of the "Comprehensive Measure for Enhancement of the Competitiveness of SMEs" announced on July 7, 2004 that includes a supportive measure for innovative venture SMEs. *Id*. at 4; *see also* Ministry of Finance and Economy et al., "중소기업 경쟁력강화 종합대책" [Comprehensive Measure for Enhancement of the Competitiveness of SMEs], 2004, *available at* http://www.mofe.go.kr/public/info14_2_3.php?action=view&t_code=741&no=82107.

The major contents of the "Measure for the Activation of Venture Businesses" include "activation of the KOSDAQ," "reform of a quotation system," "increase in guarantees for venture businesses," "promoting information circulation among venture businesses," "encouraging expansion of venture investment," and "preparing a good environment for revival of failed venture businesses." Lim et al., *supra* note 262, at 10 (translated from Korean to English).

[275] Small and Medium Business Administration, Plan for the Advancement, *supra* note 12.

[276] *See* Lim et al., *supra* note 262, at 12 (stating that "[s]ince the burst of the IT bubble, it became a policy issue to nurture an ecosystem for venture businesses overcoming the growth in quantity and size . . . .").

[277] Ministry of Finance and Economy et al., *supra* note 252, at 4.

[278] First of all, the number of venture businesses started to increase. Their number had continued to decrease, from 11,392 in 2001 to 7,967 in 2004. Following the announcement of the new policy, the number showed a drastic increase again, from 9,732 in 2005 to 12,218 in 2006. The Kosdaq index went up to a level higher than 380 by the end of 2004, after recording the lowest level of 324.71 on Aug. 4 that year. The 1 trillion-won parent fund, which was the core of the New Venture Policy, breathed life into venture businesses. The amount of the newly invested venture capital started to increase to 757.3 billion won in 2005 and 733.3 billion won in 2006, which is about 20 percent increase from the 2002-2004 period. The Kosdaq index jumped to 750 in 2005 on the back of the new

Since 1997, the government-driven policy has achieved the external growth of the venture industry.[279] There has been a numerical increase of venture businesses[280] and the growth of the venture business sector created more jobs.[281] However, it is doubtful that the increased venture enterprises have cost-effectively contributed to the substantial growth of the Korean economy[282] and successfully

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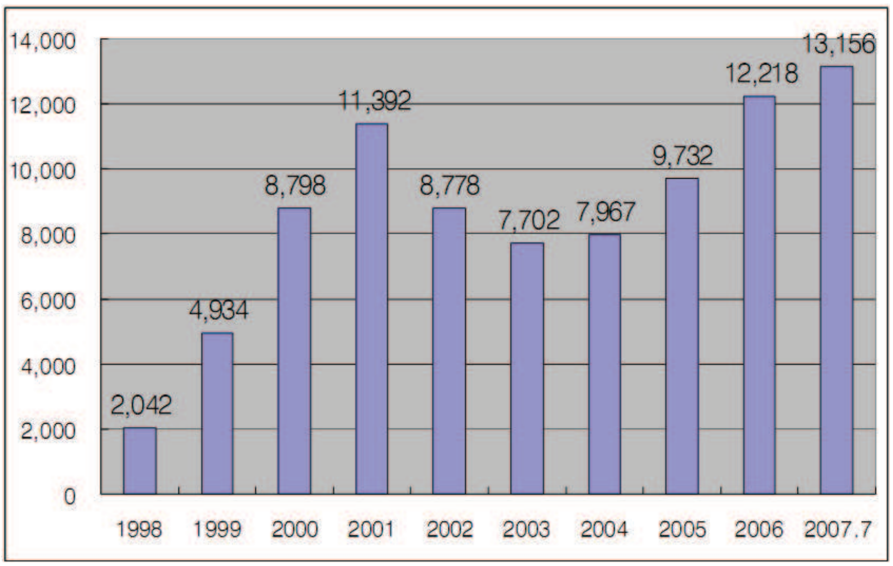
> measures, including permission for venture capital to control management, invigoration of PEF (private equity fund), and more stringent supervision of venture investment businesses.

Moon-sool Cho, *[10 years after Crisis] Venture Businesses Revived on Government Support*, THE KOREA HERALD, March 5, 2007.

[279] *See* Chae-Yoon Lim et al., "한국형 벤처생태계 활성화 방안" [Policy Recommendation for Promoting Korean Venture Ecosystem], Science and Technology Policy Institute, 2006, p 175 (stating that "[e]ven though we cannot assert that the external growth is totally attributable to the venture policy, we cannot deny that the venture policy has got much influence and effect on the growth") (translated from Korean to English), *available at* http://www.stepi.re.kr/researchpub/fulltext/P06-01.pdf.

[280] The following Figure shows the rise and fall of the number of venture businesses during the period of 1998-2007.



Source: http://www.venturein.or.kr/. KCCI, *supra* note 21, at 2.

* The number of venture businesses as of the end of April 2008 is 14,385; *see* VEBTURE-in, http://www.venturein.or.kr (last visited June 8, 2008).

> Recent statistics say that, for the last 10 years, the annual number of new start-ups in the manufacturing sector has increased by about 2.4 times from 21,831 companies in 1997 to 52,587 companies in 2005; the annual number of new venture start-ups has risen by two times from 50 companies to 100 companies; and the annual average amount of investment has grown by seven times from 90 billion won to 600 billion won.

Lim et al., *supra* note 279, at 175 (translated from Korean to English).

[281] The number of the employees in the venture business sector has increased from 75,000 in 1998 to 339,000 in 2005 - the average annual increase rate was 23.9%. During the same period, the average annual increase rate of the number of the employees in the conglomerate sector was 5.8%. KCCI, *supra* note 21, at 4.

[282] According to the current law of venture business, any enterprise including small-medium sized companies can register as venture business as long as it meets all the requirement. For that reason, it is hard to say that the quantitative increase in

restructured the Korean economy.[283] Also, it is doubtful that the numerical increase of venture businesses means they are competitive. According to the statistics of the Small and Medium Business Administration, "the proportion of venture businesses in the total annual exports in Korea has been decreasing."[284] Now, the Korean venture industry faces many challenges in promoting the substantial growth.

The distinctive characteristic of the Korean venture policy is that the Korean government takes direct measures to promote the venture industry by providing financial supports, tax benefits, and preferential regulatory treatments to government-certified venture businesses. The governmental policy is legally based on the Act on Special Measures for the Promotion of Venture Businesses.[285] Along with the KOSDAQ market, the Venture Promotion Act has served to establish the framework of the Korean venture ecosystem.[286] The Venture Promotion Act shows that the government's policy for venture businesses is basically planned-economic, not market-based. The Act sets the scope of its supports and regulations by artificially defining venture business and gives preferential benefits only to companies that fall into the statutory category.[287] The government's excessive supports for certified venture businesses make the businesses less risky.[288] And the limited chances for investment exit cause the venture capital investment to be less profitable.[289] As a result of the governmental policy combined with inefficient exit markets, the Korean venture business shows

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> venture businesses in Korea has brought up the real development of venture businesses.

Chung, *supra* note 233, at 27.

[283] *See* SHIN & CHANG, *supra* note 259, at 111 (maintaining that "it is still far from certain whether the Korean government has succeeded in turning the SME sector into an alternative engine of growth").

[284] KCCI, *supra* note 21, at 3 (translated from Korean to English).

The following table shows percentages of total exports by each enterprise sector:

Classification	**'01**	**'02**	**'03**	**'04**	**'05**	**'06**	**'07. 1-5**
Large Enterprises	57.0	57.9	57.8	64.3	67.5	67.9	67.0
SMEs	42.9	42.0	42.1	35.6	32.4	32.0	32.9
Venture Enterprises	3.7	3.7	3.7	3.6	3.6	3.4	3.4
The Others	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Source: Small and Medium Business Administration

Id. (quoted table translated from Korean to English).

[285] When the legislation was enacted in 1997, the Act was intended to be in force only for a ten-year period. However, the effective period of the law was extended to Dec. 31, 2017. *See* Supplementary Provision of the Venture Promotion Act § 2 (2007).

[286] *See* Lim et al., *supra* note 279, at 91-92 (stating that since the establishment of the KOSDAQ market and the enactment of the Venture Promotion Act, the framework of the Korean venture ecosystem, which consists of venture businesses, venture capitals and exit markets, has started to be shaped).

[287] *See supra* notes 32-38 and accompanying texts.

[288] *See* Ko & Shin, *supra* note 25, at 459 (stating that the Venture Promotion Act "protects entrepreneurs from downside risks").

[289] *See id*. (stating that "the lack of a properly functioning equity market for venture capital hinders the realization of upside potential for investors").

the feature of "limited-risk and limited-return."[290]

B. Problems Concerning Korean Venture Policies

The Korean policy for the promotion of venture businesses was intended to follow the success story of the U.S. venture industry,[291] which is based on active stock markets and "an extremely effective contracting structure that covers the entire venture capital cycle."[292] The policy goal of the Korean venture capital advancement plan is "the expansion of infrastructure for private sector leading venture investment in order to establish a market-based venture ecosystem."[293] Still, the Korean government's key policy measures are direct support and regulation based on the venture certification system. The main problem of the Korean venture promotion policy is the contradiction between the policy goal and policy measures.[294]

The contradiction between the policy goal and the methods is caused by the "status quo bias"[295] of policy makers in Korea.[296] Since 1960s, the Korean economy has grown remarkably, thanks to the government-driven economic policy.[297] For rapid growth, the economic development strategy of the Korean government focused on major conglomerates, so-called *chaebol*,[298] not small and

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[290] *Id*.

[291] *Id*. at 470 (stating that "Korea's legislative history indicates that, through the enactment of the SLPVCC, the Korean government strove to emulate the success of the United States' venture capital system") (citing Jin Hyung Kim, *Explanation on Special Law to Promote Venture Capital Companies, Venture Capital*, Fall 1997, at 2-3). *Cf.* Gilson, *supra* note 7, at 1068 (stating that "[i]t is hardly surprising, then, that other countries have sought to emulate American success in developing an effective venture capital market").

[292] *Id.* at 1093.

[293] Small and Medium Business Administration, *supra* note 12, at 1 (translated from Korean to English).

[294] *See* Ko & Shin, *supra* note 25, at 477 (maintaining that "if the underlining purpose of the [Venture Promotion Act] is to emulate the success of the United States' venture capital industry simply through the relaxation of existing laws in Korea, the measures taken thus far are inadequate and other complementary measures are needed").

[295] "The so-called *status quo bias* posits a systematic decisionmaking bias pursuant to which actors favor maintaining the status quo rather than switching to some alternative state. The status quo bias can lead to market failure where decisionmakers' preference for the status quo perpetuates suboptimal practices." Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1043-44 (2000) (emphasis changed).

[296] *Cf.* Gulinello, *supra* note 13, at 846 (stating that "nations seeking to create venture capital markets . . . may encounter certain historical, political, economic, and legal path dependencies that serve as obstacles to the organic development of a venture capital market").

[297] South Korean economic performance over the last four decades has been nothing short of spectacular. During this period the country experienced only two years of negative growth: 1980, in the wake of the second oil shock and the assassination of President Park Chung-hee, and 1998, in the midst of the Asian financial crisis.

Noland, *supra* note 244, at 2; *see also supra* note 244 and accompanying text.

[298] The definition of the chaebol is still debatable. In general, to call an entity a "chaebol," three requirements should be met: it must be (1) a conglomerate, (2) family controlled and (3) have a substantial proportion in the national economy. Jeong-Pyo Choi, The Theory and the Reality of the Korean Chaebol 6-7 (2004). Meanwhile, Dokjeom Gyuje Mit Gongjeong Georaee Gwanhan Beobryul [Monopoly Regulation and Fair Trade Act] [hereinafter, MRFTA] uses the term

medium-sized companies.[299] As the numbers of the conglomerates are relatively few, the government officers could effectively support the large enterprises intensively and preferentially. The government established a bank-centered system to financially assist the conglomerates through the banks,[300] which were controlled by the government. The long-time tradition of the bank-centered[301] and planned

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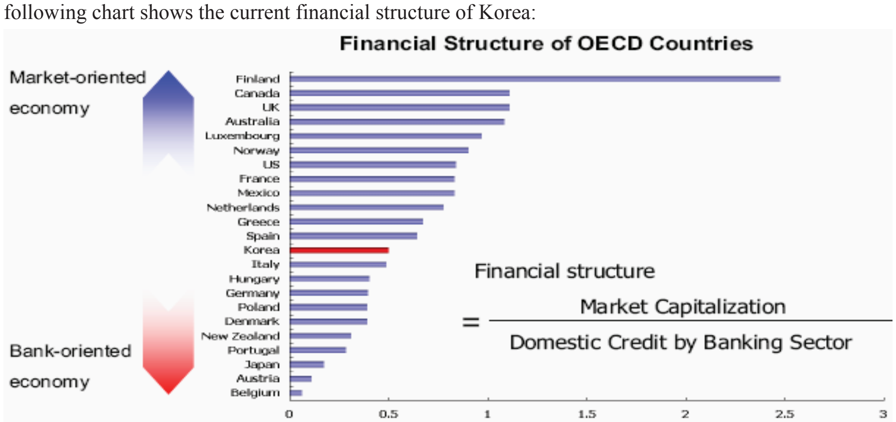
> "enterprise group," instead of the term chaebol, which is defined as a group of companies whose businesses are substantially controlled by an individual or a company (MRFTA, art. 2 (2)). Indeed, most Korean chaebols belong to the enterprise group.

Jeong Seo, *Who will Control Frankenstein? The Korean Chaebols's Corporate Governance*, 14 CARDOZO J. INT'L & COMP. L. 21, 23 (2006).

[299] Lee, *supra* note 244 (explaining that "[d]uring the 1960s and 1970s in Korea, strategic industries were designated for preferential treatment, and conglomerates, known as chaebol, solidified their growth trajectories by exploiting their exclusive business licenses"). As a result of the economic development policy favoring major conglomerates and the bank-centered financial system, "[s]maller firms suffered from a credit crunch, due to a lack of assets to use as loan collateral, the undercapitalisation of banks and an almost complete absence of equity capital." Baygan, *supra* note 9, at 14.

[300] Lee, *supra* note 244 (stating that "[t]he government constructed a bank-oriented indirect financial system, under which financial resources were allocated to industries, and firms were chosen by the government"); *see also* Baygan, *supra* note 9, at 14 (stating that "[t]he *chaebol* relied heavily on debt finance to fund their investment programmes which resulted in exceptionally high debt-equity ratios throughout the Korean industrial sector").

[301] Since the 1997 Asian financial crisis, the Korean financial system has been transforming from a bank-centered system to a capital-market system. *Cf.* National Assembly of the Republic of Korea (Issue Spotlight: The Entry of Foreign Capital into the Domestic Market) (stating that, "[i]n 1997, the International Monetary Fund (IMF) pointed out that Korea's 1997 foreign exchange crisis was caused by its bank-centered economic structure and unsound corporate management"), http://korea.assembly.go.kr/abo/zin_read.jsp?cha=1&boarditemid=1000000582 (last visited June 8, 2008). However, the current Korean financial system should be changed towards a more capital market oriented system. The following chart shows the current financial structure of Korea:



Kim, *supra* note 331, at 5.

Cf. As for the debate on bank-centered vs. stock market-based capital markets, Professors Black & Gilson states as follows:

> Advocates of bank-centered capital markets claim that this structure fosters patient capital markets and long-term planning, while a stock market-centered capital market is said to encourage short-term expectations by investors and responsive short-term strategies by managers (e.g., Edwards and Fischer, 1994; Porter, 1992). Advocates of stock market-centered systems (e.g., Gilson. 1996) stress the adaptive features of a market for corporate control which are lacking in bank-centered systems, and the lack of empirical evidence of short-termism.

economic policy is still affecting the venture policy making.

In the "Measure for the Activation of Venture Businesses" in 2004, the Korean government rightly pointed out the problems caused by the government's direct promotion policy as follows:

> □ The direct governmental involvement and the lack of the venture business evaluation system based on the market mechanism have caused inefficient allocation of resources and moral hazards of venture businesses.
>
> ○ The direct governmental support has checked the free [market] entry and exit [of venture businesses].
>
> . . . .
>
> ○ The regulatory capacity of the KOSDAQ market could not catch up with the rapid growth of the market and thus investor protection in the KOSDAQ became unsatisfactory resulting in low investor confidence.[302]

Responding to the problems, the new policy aims to "[s]trengthen the functions of the infrastructure and the capital market meeting the demands of a venture start-up, in accordance with each development stage of the company's life cycle consisting of a start-up stage, a growth stage, and a restructuring stage"[303] The major points of the new policy according to the life cycle model are as follows:

> 1. Start-Up Stage
>
> ○ Reinforcement of the investment capabilities of venture capitals, such as start-up investment companies and venture investment partnerships, which support venture start-ups
>
> ○ Constructing a revival series for honest but failed venture businesses and formulating the system to share success and failure experiences
>
> 2. Growth Stage
>
> ○ In order for stable growth of venture businesses, taking measures to improve the demand bases, such as financial support, industrial-educational cooperation, and public purchase
>
> 3. Mature · Restructuring Stage

Black & Gilson, *supra* note 6, at 244.

[302] Ministry of Finance and Economy et al., *supra* note 252, at 2 (alteration in original) (translated from Korean to English).

[303] *Id*. at 4 (translated from Korean to English).

○ Recovering investor confidence by activating the KOSDAQ market and [Free Board] (non-KOSDAQ OTC market) and facilitating early exit of ailing companies from the markets

○ Relaxation of the regulation on M&As among venture enterprises[304]

The new policy includes some market-based measures. For example, measures "to expand investment by the private sector through fund raising activities,"[305] "to deregulate on the establishment and operation of start-up investment companies,"[306] and "to establish the information infrastructure concerning venture businesses"[307] are all market-friendly. However, the government's policy is still based on the venture certification system, which is the core of the Venture Promotion Act. When the Act was enacted in 1997, it was intended to be in force only for a ten-year period. But the effective period of the Act was extended to December 31, 2017.[308] The extension shows the government's willingness to continue actively patronizing the Korean venture businesses *from cradle to grave*.[309]

The Korean government's venture promotion policy is focused on directly supporting *venture businesses*, not the *venture capital market*. Venture businesses, by nature, require environmental supports, which are infrastructures for efficient venture capital mechanisms. The efficient contractual mechanisms are a necessary condition for the success of a venture capital market.[310] As the Korean government admitted, active governmental interference with the venture industry brought about an "inefficient allocation of resources and moral hazards of venture businesses"[311] by distorting the contractual mechanisms. The government's direct promotion policy checks the development of the characteristics of efficient venture

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[304] *Id*. at 5 (alteration in original) (translated from Korean to English).

[305] *Id*. at 7 (translated from Korean to English). For that purpose, the government made the Korea Development Bank creating a two-hundred-billion Korean won (approximately two hundred million dollar) size joint investment fund with private investors. *Id*.

[306] *Id*. at 8 (translated from Korean to English). The major contents of the deregulation measure are 1) "relaxation of requirements for the establishment of the company, concerning paid-in capital amount . . . and securing professionals . . . " and 2) "permitting a start-up investment company to operate a consulting business on the side in order to meet various financial demands of venture businesses and strengthen business support services." *Id*. (translated from Korean to English).

[307] *Id*. at 10. The measure to establish the information infrastructure is "to provide trustful information for investment decision and enhances the transparency of the management by expanding the disclosure of business information on operation, finance, and technology of venture businesses." *Id*. (translated from Korean to English).

[308] *See* the Supplementary Provision of the Venture Promotion Act § 2 (2007).

[309] *See infra* note 315.

Cf. The Korean government saves "honest" venture entrepreneurs from the *grave* through the Revival Program. The Program gives governmental guarantees to failed entrepreneurs through the process, where "Korea Venture Business Association tests the morality of a qualified candidate who successfully recovered his or her credit, and then an insurance agency studies the technology and business feasibility." Ministry of Finance and Economy et al., *supra* note 252, at 9 (translated from Korean to English). The government takes entrepreneurs' know-hows and experiences as valuable social assets. *See id*.

[310] *See supra* note 291 and accompanying text.

[311] *See supra* note 301 and accompanying text.

capital relationships: the combination of strong incentive and monitoring, the combination of explicit and implicit contracts, and the combination of the VC-investor relationship and the VC fund-venture business relationship.[312]

As for the combination of strong incentive and monitoring, the governmental policy weakens incentive mechanisms and increases monitoring costs incurred by the private venture business sector. The bureaucratic definition and preferential treatment for government-certified companies prevent venture entrepreneurs from being rationally incentivized according to a reasonable cost-benefit analysis ("B/C analysis").[313] Suppose that a venture entrepreneur reasonably analyzes the costs and benefits of various business forms and concludes that a form of business organization that is out of the statutory category of the Venture Promotion Act is the most suitable for his business. If the benefits of being a government-certified venture enterprise are greater than the costs of giving up the suitable form, the entrepreneurs will choose a statutory form of venture business, irrespective of the rational B/C analysis.[314] In Korea, for small venture start-ups, the governmental supports are a considerable factor for business planning. The government's direct promotion policy based on the venture certification system serves as an additional benefit in the B/C analysis of venture entrepreneurs and impedes efficient incentive and monitoring mechanisms by distorting reasonable B/C analysis by venture entrepreneurs.[315] It encourages incapable entrepreneurs with poor business models to launch their businesses in order to receive governmental benefits,[316] which will lead to a situation ruled by "Gresham's law."[317] The increased number of incompetent venture businesses raises monitoring and screening costs incurred

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[312] *See supra* note 153 and accompanying text.

[313] *See* Ko & Shin, *supra* note 25, at 471-77.

[314] *Id*. at 472 (taking an example of the problem caused by "the specificity in defining a venture capital-backed company").

[315] *Cf.* Gulinello, *supra* note 13, at 882 (arguing that "the Taiwan experience reinforces an important point made by Professor Gilson: the government must structure its engineering efforts to ensure the participants in the market have sufficient incentives to select and monitor investments").

[316] *See* Ko & Shin, *supra* note 25, at 475 (arguing that "[i]f entrepreneurs in Korea are protected from losing their jobs so long as they do not spend more than three years experimenting with their innovations, many incompetent entrepreneurs may find it tempting to enter into the venture capital market in Korea") .

As for this situation, a venture capital expert argues that "if venture entrepreneurs don't have the confidence to grow their companies, they shouldn't start venture business in the first place." *Venture Moral Hazards (1)*, *supra* note 18.

As well as helping incompetent venture capital-backed companies start their businesses, the government's direct supports "artificially prolong the life of nonviable companies." Ko, *infra* note 345. In this sense, the Korean government patronizes venture businesses *from cradle to grave. See supra* note 309 and accompanying text.

[317] Gilson, *supra* note 7, at 1100.

Gresham's law means "[t]he principle that inferior products or practices tend to displace superior ones." BLACK'S LAW DICTIONARY 204 (Abrid. 7th ed. 2000).

Cf. Myoung Ho Lee & Hoon Huh, *A SD approach to the evaluation of Internet Venture Business: Focusing on effect of government support system and incubating system*, at 8-9 (2002) (arguing that "government funding support policies do not take on a primary role in facilitating the performance of venture businesses in the long run"), *available at* http://www.systemdynamics.org/conferences/2002/papers/Lee1.pdf.

by VCs.[318]

As for the combination of explicit and implicit contracts and the braiding of the VC-investor relationship and the VC fund-venture business relationship, the government's policy focus on the direct support of venture businesses has given rise to a failure in the establishment of infrastructure for the implicit contract mechanisms. As venture businesses are by nature dependent on ecosystem to supply capital, management and marketing advice, and other environmental supports, the government's financial supports alone cannot effectively promote the whole venture capital ecosystem. The Korean government has neglected to provide infrastructures for financial intermediaries, reputation market, and well-balanced IPO markets.[319] Those are essential for the implicit contract mechanisms and the efficient braiding of the dual contractual relationships.[320]

VCs link the dual contractual relationships, the VC-investor relationship and the VC fund-venture business relationship, by serving as financial intermediaries.[321] The government's venture promotion policy interrupts the spontaneous development of VCs' role "by having the government . . . act as the financial intermediary."[322] The dual contractual structure consisting of the VC-investor relationship and the VC fund-venture business relationship enhances the efficiency of a venture capital contract by reducing the risks associated with venture investment.[323] The government's active interference with the venture capital market prevents market players from efficiently forming dual contractual relationships. Also, the government's direct support makes the market actors opportunistic players,[324] not continuing players; therefore, it impedes the establishment of reputation market.[325]

More importantly, the government-driven policy for the promotion of venture businesses has resulted in unbalanced exit markets. The Korean government has attached importance only to the KOSDAQ market as an exit market to grow rapidly the venture industry.[326] Since the KOSDAQ market was created in 1996, the market has served as an infrastructure for the governmental

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318 Ko & Shin, *supra* note 25, at 475.

319 In Korea, the stock markets, as IPO markets, include Korean Stock Market (KSM), KOSDAQ market, and Free Board. The KSM "is the market for the big and superior firms' shares, and the KOSDAQ for small-to-medium enterprises and venture firms, while the shares not listed but designated by the KSDA are traded on the Free Board." The Stock Markets "Overview" section of Korea Securities Dealers Association (KSDA), http://www.ksda.or.kr/english/invest/stock_overview.cfm (last visited June 8, 2008).

320 *See* Black & Gilson, *supra* note 6, at 245 (arguing that the implicit contract mechanism is based on the "availability of exit through an IPO"); Gilson, *supra* note 7, at 1091 (arguing that the mechanisms of the reputation market and the investment exit create the braiding of the two contractual relationships).

321 *See supra* note 61 and accompanying text (stating that "VCs serve as intermediaries between venture businesses and outside investors to balance both parties' interests").

322 Gilson, *supra* note 7, at 1070.

323 *See supra* note 189 and accompanying text.

324 *See supra* note 301 and accompanying text.

325 *See supra* note 239 and accompanying text.

326 Shin, *supra* note 15, at 18 (stating that "the Korean government drove the development of the KOSDAQ market because it desired faster growth when development of financial institutions lagged").

policy to encourage venture businesses.[327] The Korean government promoted the KOSDAQ market in various ways such as providing a monopolistic status to the KOSDAQ market,[328] easing listing standards, and giving tax benefits.[329] Consequently, the KOSDAQ market has grown as one of the world's largest markets for high-tech venture enterprises in terms of trading volume[330] and aggregate value of listed stocks.[331] However, other exit markets such as the M&A market[332] and, Free Board,[333] an OTC[334] market, are left underdeveloped and

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[327] *Cf. S. Korea Unveils Measures to Revive Venture Sector*, ASIA PULSE, Dec. 24, 2004 (reporting that "[t]he South Korean government will give venture firms tax breaks and ramp up efforts to stimulate the minor bourse in a bid to foster a *second venture boom*") (emphasis changed).

[328] The pseudo-stock trading facilities other than KSM, KOSDAQ, and the derivatives exchange have not been legislatively allowed in Korea. *See* Kyong-shik Eom, *Enhancing Korea's Power in Global Markets*, THE KOREA HERALD, May 22, 2008.

Article 386 of Financial Investment Services and Capital Market Act provides as follows:

> (1) Trading markets for financial investment products established by the Exchange shall be as follows:
>
> 1. The securities market;
>
> 2. The KOSDAQ; and
>
> 3. The derivatives market.
>
> (2) Any person other than the Exchange shall not establish the markets under paragraph (1) or any other similar facility and shall not trade securities or exchange-traded derivatives through any other similar facility.

Financial Investment Services and Capital Market Act § 386 (Act No.8635, 2007), *available at* http://www.fsc.go.kr/jb/jb0601/list.jsp?menu=010101&bbsid=BBS0082.

[329] *See* KSDA, *supra* note 15, at 59.

[330] Gwang-lip Moon, *KRX Chief Has Big Plans for KOSDAQ: First Step Is to Make It Easier and Cheaper for Firms to List There*, JOONGANG DAILY (English Edition), March 25, 2008 (reporting that "daily trade volume on the Kosdaq was 650 million shares worth 2.6 trillion won ($2.6 billion) as of September 2007, second to the U.S. Nasdaq") *available at* http://joongangdaily.joins.com/article/view.asp?aid=2887807.

[331] The world-wide ranking of stock markets for venture capital-backed companies in terms of aggregate value of listed stocks is as follows:

(A Hundred Million Dollar, %)

	Ranking	As of End of 2005	As of End of 2004
NASDAQ (U.S.)	1	36,039.8 (2.0)	35,329.1
JASDAQ (Japan)	2	1,639.2 (35.9)	1,205.8
AIM (UK)	3	972.0 (59.5)	609.6
KOSDAQ (Korea)	4	701.4 (133.1)	300.9
Mothers (Japan)	5	593.4 (88.5)	314.9

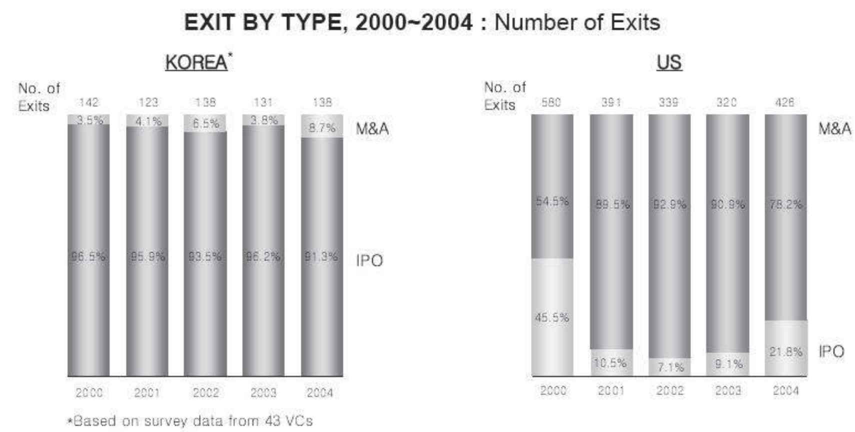
Note: The numbers in the parentheses are growth rates compared with last year

Source: WFE (World Federation of Exchanges) DB

This table is a translated version of a table contained in Jong Nyun Kim et al., "코스닥 10년, 회고와 과제" [*The Ten Years of KOSDAQ: Review and Problems*], SAMSUNG ECONOMIC RESEARCH INSTITUTE, p. 5, *available at* http://www.seri.org/db/dbReptV.html?menu=db02&pubkey=db20060628001.

[332] In Korea, M&As account for only one-digit percent of the total investment exit cases, while M&As are an overwhelming majority of the exit cases in the U.S.

The following figure shows the comparison between Korean and U.S. M&A exit markets:



Source :KVCA; National Venture Capital Association (NVCA)

Dosoung Choi, Presentation at OECD/ADBI 7th Round Table on Capital Market Reform in Asia Venture Capital and Private Equity in Korea, at 19 (Oct. 27-28, 2005) (Source of the US Exit Chart: NVCA Yearbook (2005)), *available at* http://www.oecd.org/dataoecd/7/5/35531841.pdf.

[333] As a governmental policy, Free Board, formally called "Third Market," has been opened to help venture capital-backed companies' financing. Free Board is the only officially organized non-KOSDAQ OTC market "for companies listed, neither on the Stock Market Division nor on the KOSDAQ Market Division of KRX." Korea Securities Dealers Association (KSDA), http://www.ksda.or.kr/english/invest/otc_overview.cfm (last visited June 8, 2008). For detailed provisions on over-the-counter transactions, *see* Enforcement Decree of KSEA § 84-27 (2008). "Sale and purchase transactions of securities outside the securities market and the KOSDAQ, method of their settlement and other necessary matters shall be determined by the Presidential Decree." KSEA § 194(1) (2008); *see also* So-young Kim, *New Market Formed for Venture Firms: Freeboard Replaces Third Market*, THE KOREA HERALD, July 14, 2005 (Hwang Kun-ho, president of the Korea Securities Dealers Association which operates Free Board said, "[o]ut of more than 8,500 venture firms, only 376 companies, or 4 percent, are listed on the Kosdaq. Freeboard could therefore emerge as a new alternative market of venture companies"); KSDA, *supra* note 15, at 124 (stating that "[t]he name, '*FreeBoard*,' signifies the KSDA's ambition to nurture it as a market where stocks are freely traded under minimum regulations and at low cost") (emphasis changed).

The number of registered companies and the trading volume and value on Free Board have been in a downward trend. *See* Jung Han Koo, "프리보드 활성화 과제" [*Tasks for the Activation of Free Board]*, Weekly Financial Briefs, 16 KOREAN INST. OF FIN. NO. 38.1, 12-13.1 (2007), *available at* http://www.kif.re.kr/KMFileDir/128354894275000000_16-38-f2.PDF.

The following table shows the trade comparison among three stock markets in Korea:

	KSM	**KOSDAQ**	**Free Board**
Monthly Trading Volume (Sum of Feb. / March of 2008)	5,768 / 6,077	9,031 / 9,815	1.94 / 3.75
Monthly Trading Value (Sum of Feb. / March of 2008)	84,383,559 / 101,181,797	25,591,142 / 27,219,723	2,619 / 7,008

Unit: Million Won, Million Shares

The table is created based on each market's official statistics. For the data, *see* FREE BOARD, http://www.freeboard.or.kr (last visited June 8, 2008); KRX, http://www.krx.co.kr (last visited June 8, 2008).

The following table of the statistics for trading on Free Board shows that the market is becoming stagnant.

inactive.[335] The excessively limited exit opportunities in M&A and OTC markets drive many small venture enterprises that cannot satisfy the listing standards of the KOSDAQ market to seek a regulation-evading technique for the KOSDAQ listing, such as backdoor listing on the KOSDAQ market.[336] In addition, the government's KOSDAQ-centered *one-size-fits-all* exit market policy[337] caused a situation dominated by Gresham's law and made competent and qualified companies on the KOSDAQ market move up to the Korean Stock Market.[338] There have been many market anomalies and illegal or unfair stock trading practices such as securities fraud and market manipulation in the KOSDAQ market,[339] which undermines the market's quality and investor confidence.[340]

Category	2000	2001	2002	2003	2004	2005	2006
Market Capitalization (KRW trillion)	1.03	1.29	1.37	1.08	0.38	0.44	0.42
Average Daily Trading Value (KRW million)	674	341	241	70	41	75	77
Average Daily Transaction Rate*(%)	81.3	55.8	38.4	29.6	28.3	36.1	36.8

Note: *Average Daily Transaction Rate = Number of issues traded / Number of issues listed*

Source: Korea Securities Dealers Association (KSDA)

KSDA, *supra* note 15, at 127. "The Board enjoyed its peak in late 2002, with 183 listed issues at the end of the year. As the IT bubble burst and liquidity dried up, the number of listed issues had fallen to 56 as of year-end 2006." *Id*.

334 Over-The-Counter ("OTC") is defined as a "security traded in some context other than on a formal exchange such as the NYSE, TSX, AMEX, [NASDAQ], etc. The phrase *over-the-counter* can be used to refer to stocks that trade via a dealer network as opposed to on a centralized exchange." INVESTOPEDIA, http://www.investopedia.com/terms/o/otc.asp (emphasis changed) (last visited June 8, 2008).

335 In this sense, the Korean "government venture policy face[s] the significant level of bottlenecks due to insufficient exit market in bringing successful implementation." Youngseok Yang & Hoyoung Hwang, "사회 연결망 이론(Social Network Theory)을 이용한 시장중심 벤처육성시스템의 진화도 및 타당성 분석 – 벤처자금순환 연결망 분석을 중심으로" [*Evolutionary and Validity Analysis of Korean New Venture Promotion Policy by Utilizing Social Network Theory - In the center of Venture Financing Circular Network*], 7 KOREAN ASSOC'N OF APPLIED ECON. 214 (2005), *available at* http://www.kaae.or.kr/images/7-1/719_yys.pdf.

336 *See* Ja-young Yoon, *'Momentum' Stocks Underperform*, THE KOREA HERALD, Dec. 26, 2006 (reporting that "[a] series of entertainment firms, which do not satisfy the standards for a new listing, chose backdoor listings as a shortcut to get on the bourse").

337 In the current one-size-fits-all exit market system in Korea, the KOSDAQ market face a dilemma in keeping the proper level of the listing standards: if the listing standards are low, many problems such as market manipulation, stock price bubble, and moral hazards will prevail on the KOSDAQ and ultimately undermine investor confidence and market integrity; while, on the other hand, if the listing standards are high, investors on small-cap venture enterprises will lose opportunities for exiting investment on the KOSDAQ.

338 *See* Hyong-ki Park, *KOSDAQ Firms Eye Listing on KOSPI*, THE KOREA HERALD, Feb. 28, 2008 (reporting that "[a] number of large-cap companies listed on the tech-heavy Kosdaq market are taking a U-turn and heading toward the benchmark KOSPI market, citing that it is better to list on the main bourse due to its stability and image"). In this context, the KOSPI market means the KSM.

339 *S Korea's KOSDAQ Market*, *supra* note 271 (reporting that the KOSDAQ "market has been marked by frequent fluctuations and other unwelcome events, such as embezzlement and stock price

VI. SUGGESTIONS FOR KOREAN POLICIES TO PROMOTE VENTURE BUSINESSES

The fundamental problem of the Korean venture promotion policy is the discrepancy between the policy goal and the policy measures. The policy goal and the measures should be matched in a market-friendly way. In promoting venture businesses, a market-based policy is more efficient than a planned economic policy. As shown in the U.S. venture capital market model, the private ordering among market players is the secret of success of the U.S. venture capital industry.

The planned economic policy for promoting venture businesses, under which the government serves as both capital provider and financial intermediary, cannot efficiently reduce the risks[341] associated with venture capital investment and rather distorts the incentive and monitoring mechanisms.[342] As the venture business is an innovative and risky business, the investment in the business requires special expertise and experience to appreciate the commercial value of innovation and manage the business risk.[343] In addition, as a venture business is usually a start-up without business experience, specialized investors are demanded to give it management support.[344] The "innovative," "risky," and "immature" characteristics of a venture business require venture investors to be willing and able to provide management assistance and business monitoring as well as capital. The public officers do not have capacity to choose competent start-ups and to assist and monitor the selected companies.[345] They cannot efficiently engineer the venture capital market system because the system is too complex to be controlled by a centralized authority.[346] In addition, they do not have the right incentives[347] but

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manipulations").

[340] *See* Miki Tanikawa, *Small-Cap, Big Problems; Investors Shun South Korea's Tech-Heavy 2nd Market*, THE INTERNATIONAL HERALD-TRIBUNE, Aug. 26, 2004 (reporting a securities expert's statement that, in the KOSDAQ market, "[i]nvestor sentiment has collapsed because so many companies have deceived so many investors").

[341] *See* Gilson, *supra* note 7, at 1070.

[342] *See* Gulinello, *supra* note 13, at 860.

[343] Also, the expertise and experience are required "for market participants to police one another and detect uncooperative behavior." Paredes, *supra* note 231, at 1115.

[344] With [his or her] experience, the venture capitalist can assist a management-thin early-stage company in locating and recruiting the management and technical personnel it needs as its business grows, and can help the company through the predictable problems that high-technology firms face in moving from prototype development to production, marketing, and distribution. The venture capital fund's industry knowledge and experience with prior startup firms helps it locate managers for new startups.

Black & Gilson, *supra* note 6, at 252-53.

[345] *See* Kyoung-tae Ko, *[SME FINANCE(2)] Seoul Selective in Financing Small Companies: State Support Focuses on Innovative Firms, But Experts Still Doubt Effectiveness*, THE KOREA HERALD, Oct. 26, 2006 (reporting an interview with an engineer who states that government officers "didn't know anything about technology and business").

[346] The more grows the Korean venture capital industry, the harder becomes the promotion and regulation on the industry. *Cf.* Noland, *supra* note 244 (stating that "[t]he main ongoing concern in South Korea is . . . the lending culture of South Korean financial sector firms and the capacity of South Korean authorities to successfully regulate the more complex financial system enabled by liberalization").

[347] *Cf.* The government's purpose of venture business funding is different from VCs' funding as follows:

rather cause moral hazard problems.[348] Therefore, the government can neither substitute for "a specialized financial intermediary"[349] nor efficiently design the contractual structure of the venture capital investment.

The Korean government must change the policy approach to the development of the venture industry: from the direct involvement in the market to the market-based infrastructural support. Professor Gilson's "simultaneity" theory suggests the details of the government's role in promoting the venture capital ecosystem. Professor Gilson emphasizes the government's role in settling "the simultaneity problem when market forces are not likely to do so."[350] A venture capital market consists of venture entrepreneurs, venture investors as capital providers, and VCs as sophisticated financial intermediaries who link the entrepreneurs and investors through the mechanism of a dual contractual structure.[351] Professor Gilson argues that if the government provides the venture capital market with seed money and nurtures sophisticated financial intermediaries, more venture entrepreneurs will come out in the market.[352] A note of caution is that the government should invest public funds in *venture capital funds*,[353] not directly in *venture businesses*, and let the fund managers select and monitor portfolio companies without governmental influence.[354] The government should not interfere with prescreening by financial intermediaries and the incentive and monitoring mechanisms among market participants.[355] In addition to nurturing financial intermediaries, the government must establish the infrastructure for efficient private ordering by the intermediaries. The infrastructure must include reputation and exit markets, which support the incentive and monitoring mechanisms created by the explicit and implicit contracts.[356] The implication of the "implicit contract" and "simultaneity" theories for the Korean venture policy is that 1) the government must abolish the venture business certification system[357]

> The government sought only the success of the technology and its use in research. But capital market intermediaries had not only the obligation to develop the technology and its applications successfully, but the additional substantial obligation to do this in a way which promised to bring private investors a return on their investments in firms which brought innovations to the market. That is, an innovation backed by capital market institutions has not only to be useful but profitable.

D. QUINN MILLS, BUY LIE, AND SELL HIGH; HOW INVESTORS LOST OUT ON ENRON AND THE INTERNET BUBBLE 13 (2002).

[348] *See* Ko & Shin, *supra* note 25, at 474 (contending that "too much power in the hands of a few government officials may . . . breed corruption").

[349] Gilson, *supra* note 7, at 1070.

[350] Gulinello, *supra* note 13, at 846 (citing Gilson, *supra* note 7, at 1099-1101).

[351] Gilson, *supra* note 7, at 1093.

[352] *Id.* at 1094.

[353] Public funds are required *only* "to 'jump start' private equity markets." John Armour & Douglas Cumming, *The Legal Road To Replicating Silicon Valley* 38 (ESRC Centre for Business Research, University of Cambridge, Working Paper No. 281, 2004), *available at* http://www.cbr.cam.ac.uk/pdf/WP281.pdf.

[354] Otherwise, "the public money may actually 'crowd out' investment from the private sector." *Id.* at 9.

[355] *See* Gilson, *supra* note 7, at 1099.

[356] *See id.* at 1091-92.

[357] Lim et al., *supra* note 262, at 275.

and 2) the government should concentrate on establishing infrastructures[358] for an efficient venture capital ecosystem, which creates efficient incentive and monitoring mechanisms and a virtuous cycle of venture capital.

The Korean government certifies venture businesses with statutory definition and administrative discretion[359] and provides excessive supports to the certified start-up companies.[360] As the venture capital promotion programs of Israel, Chile, and Taiwan suggest,[361] the government's policy should neither influence investment decisions of market participants nor distort their incentive and monitoring structure.[362] However, the venture business certification system in Korea prevents market participants from being incentivized and behaving according to a reasonable B/C analysis. The costs of the venture business certification system are very high because it causes venture entrepreneurs to behave in accordance with the public policy goal, not with the economic B/C analysis, even from the stage of business planning and organization.[363] Once a start-up is certified as a venture business, the company receives various kinds of preferential treatments such as public funding, credit guarantee, and other investment support. Those benefits for the certified venture business result in weakening venture businesses' "self-regenerating ability"[364] and increasing monitoring and screening costs incurred by financial intermediaries.[365] The venture business certification system is an obstacle to the Korean government's new policy goal of reinforcing "the functions of the infrastructure and the capital market."[366] Therefore, the venture business certification system and similar government programs[367] should be abrogated.

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[358] The infrastructures necessarily include balanced IPO markets. *See infra* note 369 and accompanying text.

[359] For an explanation of the dilemma between statutory definition and administrative discretion, *see supra* note 35 and accompanying text.

[360] *See supra* notes 33-34 and accompanying text.

[361] For examples of the Israeli Yozma program and the Chilean CORFU program, *see* Gilson, *supra* note 7, at 1097-99. For the venture promotion case of Taiwan, *see* Gulinello, *supra* note 13.

[362] In this sense, the venture business certification system infringes the "requirement of allocative passivity, [which] is central to carving out an effective governmental role in engineering a venture capital market." Gilson, *supra* note 7, at 1100.

[363] *See* Ko & Shin, *supra* note 25, at 472.

[364] Editorial, *Classic Venture Capital*, THE KOREA HERALD, June 10, 2005.

[365] *See supra* note 318, and accompanying text.

[366] *See supra* note 302 and accompanying text.

[367] It is problematic that the governmental supports of the programs for venture businesses and SMEs are in many respects overlapping. As well as the venture certification program, there are other similar venture business promotion programs in Korea, such as the INNOBIZ certification program. *See* INNOBIZ, http://www.innobiz.or.kr/english/main.asp (last visited June 8, 2008). The INNOBIZ certification system is legally based on Technology Innovation Promotion Act for Small and Medium-sized Enterprises § 15 (2007). Excessive governmental influence on the venture capital market sector by overlapping venture promotion programs damages the efficiency of private ordering and results in inefficient distribution of administrative and economic resources. The government should effectively concentrate the governmental resources and efforts for the promotion of venture businesses by unifying the distracted venture promotion programs. As for the allocation of the governmental resources and efforts, if the government concludes that a sector of a venture industry should be encouraged, it can intensively promote the sector. Before executing the promotion policy, however, the government must evaluate the policy's influence on the private sector to check if the governmental intervention distorts the venture capital contract mechanisms. Then, the government can promote the specific sector of a

The Korean government should concentrate on building infrastructures for the efficient venture capital market such as the following: fostering competent VCs, which have capability and incentive to filter off incompetent firms and develop promising venture enterprises;[368] building a venture business-friendly legal environment to increase venture capital funding;[369] and establishing active and balanced IPO markets[370] to facilitate the virtuous venture capital cycle.[371] Currently, the government is supporting training programs for VCs to foster competent financial intermediaries.[372] In connection with nurturing VCs, the government should not interfere with VCs' intermediary activities in the venture capital market, bearing in mind its role for "passive investment in a highly incentivized intermediary."[373] As for legal infrastructure for the venture capital market, the newly legislated "Financial Investment Services and Capital Market Act"[374] is intended to improve the legal environment for the venture capital market. The act is expected to facilitate private equity investment[375] and to grow the capital market sector in Korea.[376] Also, the enhanced investor protection under

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venture industry considering the characteristics of the business or industry sector.

One of the main problems concerning the government's direct support is the uniformity. Some experts in Korea point out the "weakness in the development of various policies depending on characteristics of each venture business and each industry sector." Lim et al., *supra* note 262, at 12 (translated from Korean to English). They argue as follows:

> The current policy for promoting venture businesses lays disproportionate emphasis on function-based supports such as supports for capital, technology development and human resources and thus fails to meet the various demands depending on the growth stage of venture businesses.
>
> Venture businesses require different management resources according to their growth stage. Accordingly, in order to support venture businesses efficiently, the governmental policy should consider the growth stage and the characteristic of the industry sector where a venture business belongs.

Id. (translated from Korean to English).

368 Sung-hoon Cho, *Efficient Markets Vital to Venture Firm Growth*, THE KOREA HEARLD, June 12, 2008 (arguing that "it is necessary to enhance venture capitalists' skills to assess the value of a technology or a business model in order to promote investments in early-stage venture businesses").

369 *See* Armour & Cumming, *supra* note 353, at 37 (arguing that "[f]avourable tax and legal environments facilitate the establishment of venture capital and private equity funds and increase the supply of capital").

370 *See* Ko & Shin, *supra* note 25, at 477 (arguing that "priority must be granted to continue efforts in developing a sound financial infrastructure [in Korea], including the development of a well-functioning stock market").

371 In addition, if necessary, the government as an infrastructure provider has to provide environmental supports such as an "educated workforce," "funding for basic and translational research," "strong patent laws," "proactive technology transfer," and "a science-based regulatory environment." Wyse, *supra* note 2, at 1285-87.

372 *See* Small and Medium Business Administration, *supra* note 12, at 18.

373 Gilson, *supra* note 7, at 1102.

374 Financial Investment Services and Capital Market Act § 386 (2007).

375 *See* Jung-youn Park, *Capital Market Set to Undergo Sweeping Changes*, THE KOREA HERALD, May 29, 2007 (reporting an interview with Dr. Hyoung-tae Kim stating that "under the new capital market act, we expect private equity funds to take the role of principal sponsors of investment").

376 *See generally* Dong-hwan Kim, *Capital Market Act to Overhaul Financial Sector*, THE KOREA HERALD, June 2, 2008; *Capital Market Act to Boost Securities Sector*, THE KOREA HERALD, June 13, 2007.

the act[377] would increase the investor confidence and therefore "expand[] the scope of capital markets."[378]

However, the infrastructure for exiting investment is underdeveloped in Korea. The activation of Free Board or a junior stock exchange for small and micro-cap venture enterprises is required for investment exit and public financing for small venture enterprises. A non-KOSDAQ lower-level stock market, Free Board, has long been depressed and the prospects of the market are gloomy. Now that there is no junior market to the KOSDAQ, Free Board is important as both a pre-KOSDAQ OTC market and an exit market for small-sized venture enterprises.[379] There are some clear reasons why Free Board is depressed and short of liquidity. The trading method of Free Board is a negotiated trading not a competitive auction trading and the capital gain tax is not as broadly exempted in Free Board as in the KOSDAQ market.[380] Therefore, it takes much more transactional efforts and costs to trade on Free Board than on the KOSDAQ. To revitalize Free Board, the government should lower the transaction costs in the market by reducing transaction-related taxes as favorably as in the KOSDAQ.[381] The trading method of Free Board should also be changed from negotiated trading to competitive auction trading.[382] The favorable taxation and convenient trading system will induce many investors to trade on Free Board and accordingly expand the investor base of the market.[383]

More importantly, the government must change the point of view from the *one-size-fits-all* KOSDAQ-based market system to the two-tiered IPO market system for hi-tech venture enterprises.[384] The two-tiered IPO market system for

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377 *See* Kim, *supra* note 376 (stating that "the act will upgrade the investor protection mechanism to a global standard, equipped with accountability, suitability, a know-your-customer rule, and various measures preventing conflict of interest").

378 Rafael La Porta et al., *Legal Determinants of External Finance*, 52 JOURNAL OF FINANCE 1131, 1149 (1997).

379 *See* Kyong Shik Eom, "프리보드 발전 방안" [A Plan for the Development of Free Board], Presentation at Symposium on the Promotion of Innovative SMEs and the Development of Free Board, Korea Securities Dealers Association, 2006, at 20-26 (arguing that Free Board should serve as an OTC market for "Information Platform" and "Nurturing Innovation" and a "Junior Market"), *available at* http://www.freeboard.or.kr/m04/pds_cont.jsp?cseq=174; *see also* Jung-youn Park, *[SMI FINANCE(3)]Venture Capital Offers New Way to Finance SMEs :This is the Third in a Series of Articles on the Latest Developments in Finance Services for Small Enterprises*, THE KOREA HERALD, Nov. 2, 2006 (reporting that "[e]xperts . . . point out that the nation's Freeboard, or the third securities market for trading shares of companies that are not listed on either the Korea Composite Stock Price Index or Kosdaq, should become more active").

380 *See* FREE BOARD, http://www.freeboard.or.kr (last visited June 8, 2008).

381 *See* Koo, *supra* note 333, at 13.

382 *See id*.

383 The legal obstacle to the development of Free Board's trading system is Article 386 of Financial Investment Services and Capital Market Act.

Improvement of the trading system of Free Board may violate Article 386. In this regard, Article 386 checks the long-term development of OTC markets in Korea. Historically, Article 386 may have contributed to the rapid growth of KSM, KOSDAQ, and the derivatives exchange in Korea by providing a monopolistic status to those exchanges. However, the Article deprives those exchanges of opportunities to develop through stock market competition. KRX, the operator of those exchanges, is planning to perform an IPO. It is desirable that Article 386 prohibiting the "pseudo-trading facilities" should be relaxed. Eom, *supra* note 328.

384 The combination of the two-tiered markets could be the KOSDAQ market and a junior market to

venture businesses, consisting of the KOSDAQ market and Free Board or of the KOSDAQ and a junior market to the KOSDAQ, is required both to keep the quality of a KOSDAQ market and to satisfy the IPO demands from micro or small-cap venture enterprises[385] in Free Board or a junior market to the KOSDAQ. As the implicit contract theory suggests, the availability of IPOs for a wide spectrum of venture enterprises incentivizes venture entrepreneurs to strive for the success of their businesses and it enables the stock markets to grow in quality and quantity by providing the markets with more competent venture enterprises.[386] Then, the development of the stock markets will enhance the availability of IPOs for venture enterprises[387] and give venture entrepreneurs stronger incentives for the success of

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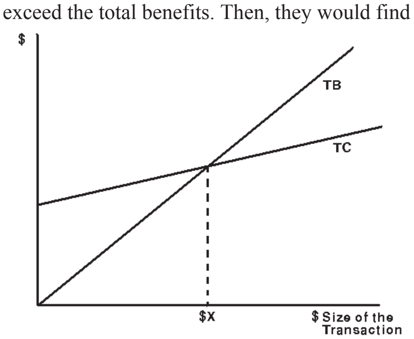
the KOSDAQ. The three-tiered IPO market system, consisting of the KOSDAQ market, a junior market to the KOSDAQ, and Free Board, would be more ideal. However, considering the size of the Korean financial market, the activation of the three-tiered IPO markets is hard to achieve.

385 The small companies' responses to higher disclosure requirements in a stock market are the results of balancing of the costs and benefits caused by the increased disclosures. Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 JOURNAL OF ACCOUNTING AND ECONOMICS. 233, 240 (2005). The fixed costs of complying with disclosure requirements are burdensome on the small companies. Accordingly, as implied by following figure, many small companies would conclude that the total costs of disclosure exceed the total benefits. Then, they would find a less regulated OTC stock market.



TB symbolizes the total benefits of registration: TB = y·S.

TC represents the total costs of registration: TC = FC + x·S.

If the dollar amount of a transaction is less than $X, the costs exceed the benefits. Thus, registration requirements for the transaction are economically inefficient. This figure well explains economics of small size offering exemptions.

Originally, this Figure was created by Prof. Bradford to explain the economics of the small offering exemptions. C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933*: *An Economic Analysis*, 45 EMORY L. J. 591, 617 (1996).

386 Black & Gilson, *supra* note 6, at 268; *cf.* Wyse, *supra* note 2, at 1287 (arguing that "[t]here is a common misconception that an abundance of venture capital will spawn the formation of new companies. In fact, the opposite is true: high-quality new companies will attract venture capital").

387 A recent empirical study in the U.S. implies the importance of the multi-tiered stock market system. According to the study, the imposition of strengthened mandatory disclosure requirements on small-sized companies results in compelling them to move to a "less regulated market" rather than forcing them to disclose more information to investors. Bushee & Leuz, *supra* note 385, at 261.

In 1999, the SEC approved the NASD's eligibility rule for the OTC Bulletin Board market, which mandates all companies quoted on the OTCBB to file periodic reports under the 1934 Act. The background on the rule making is as follows: "In the late 1990s, . . .the SEC noted a surge in OTCBB securities fraud. The SEC then determined that it should bring small OTCBB companies, including those falling below the size and shareholder limits set out in the Exchange Act, under the same reporting standards applicable to larger public companies." Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley*, 41 WILLAMETTE L. REV. 707, 717 (2005); *see also* Press Release, NASD, NASD Announces SEC Approval of OTC Bulletin Board Eligibility Rule (Jan. 6, 1999), (http://www.otcbb.com/news/EligibilityRule/eligrulepressrel.stm).

Responding to the extension of mandatory disclosure requirements under the eligibility rule, a majority of the small-sized non-reporting companies quoted on the OTCBB moved to the less regulated Pink Sheets market, rather than complied with the increased disclosure requirements. "In this regard, the Pink Sheets may have played an important role." Bushee & Leuz, *supra* note 385, at 261.

their businesses.[388] To sum up, when the venture capital infrastructures including competent VCs, a venture business-friendly legal environment, and active IPO markets are satisfied, as the simultaneity theory implies,[389] many qualified venture businesses will spontaneously appear in the Korean venture capital ecosystem.

VII. CONCLUSION

Policy makers in Korea should keep in mind that the success of the U.S. venture business industry is attributed to private ordering among market players[390] and venture capital cycle based on active IPO markets.[391] They should understand the mechanism where inputs of seed capital and financial intermediaries in the venture business-friendly environment make a success of some venture businesses, especially in the form of IPOs,[392] and the success attracts more capital and financial intermediaries from the private sector achieving a bigger success of

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We can extend the implication of the study to the case of the KOSDAQ market. Suppose the regulatory authority strengthens the listing standards of the KOSDAQ to enhance the quality of the market. As venture start-ups are usually smaller than the formally listed companies on the KOSDAQ, some of the companies cannot meet the strict listing standards and the other companies would judge that the total costs of disclosure compliance are greater than the overall benefits. Accordingly, the small venture enterprises would be likely to move to the less regulated OTC market, Free Board, rather than to comply with the reinforced listing requirements. *See id*. at 235 (arguing that "an important consequence of mandatory SEC disclosures is to push smaller firms with lower outside financing needs into a less regulated market, rather than to compel them to adopt higher disclosure standards").

[388] Consequently, active IPO markets support virtuous cycles in both corporate and financial sectors. The virtuous cycle in the corporate sector, as mentioned above, is created by the availability of IPOs, which incentivizes venture entrepreneurs to strive for the success of their businesses. Regarding the financial sector, as the venture capital cycle theory suggests, active exit markets serve as an infrastructure for venture capital investors to realize satisfactory investment returns and the successful exits help VCs raise successor funds by attracting potential venture investors with track records. GOMPERS & LERNER, *supra* note 40, at 345. For an example, *see* Gilson, *supra* note 7, at 1101 (stating that "[s]uccessful performance by early KKR funds attracted much more private investment into the private equity market, led to the creation of many more funds, and generally fueled the private equity market's restructuring of U.S. industry") (citing GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 79-80 (1998)).

The virtuous cycles in both financial and corporate sectors make market players act as continuing players: VCs keep on raising successor funds for new venture investment and venture entrepreneurs continue managing their enterprises as VCs come to return their corporate control after the event of investment exit. *See* Black & Gilson, *supra* note 6, at 243 (stating that venture entrepreneurs "reacquire control from the venture capitalist by using an initial public offering as the means by which the venture capitalist exits from a portfolio investment").

The repeat playing of market participants is one of the essential requirements for private ordering and reputation market. *See supra* notes 140 and 232. The reputational sanction enforces implicit contracts among venture capital market players. Gilson, *supra* note 7, at 1086 and 1090.

[389] *See* Gilson, *supra* note 7, at 1094.

[390] *See supra* note 291 and accompanying text.

[391] As the venture capital theory and the success of the U.S. venture capital industry imply, private equity financing is more efficient type of financing for small and medium-sized venture enterprises than debt financing. Let alone the efficiency argument, the stern reality is that banks, which are usually risk averse, are not willing to provide financing to venture businesses for lack of their track records and assets for collateral. *See supra* note 39 and accompanying text.

[392] *See* Oehler, *supra* note 59, at 492 (arguing that "[i]f history is any guide, the majority of [sic] venture capitalists' investments will ultimately prove unsuccessful, but the benefits of even a single successful IPO will usually more than make up for the losses incurred through failed investments").

venture businesses;[393] which creates virtuous cycles in the both finance and corporate sectors of venture business industry. To make the virtuous cycles, the Korean government must abolish the venture certification system and adopt capital market-friendly venture policies. Also, the government should shift the policy emphasis from the expansion of the KOSDAQ for boosting the venture industry[394] to the balanced development of each exit market to support the spontaneous growth of the venture ecosystem.

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[393] *See supra* note 230 and accompanying text.

[394] The current trend of regulating listing rules of the KOSDAQ market is to ease the listing standards and reinforce the delisting standards. *See* Hyong-ki Park, *Regulators to Make Listing Easier Next Year*, THE KOREA HERALD, Nov. 14, 2007; Moon, *supra* note 330. This policy may be efficient for expanding the stock market and boosting the venture industry in a short time. However, the policy poses a risk that the stock market may turn into a lemon market by operation of Gresham's law. Consequently, small and individual investors may suffer the side effects of this type of economic development by innovation. If the KOSDAQ listing standards become more relaxed, more individual investors will fall victims to underperforming or delisting companies. The KOSDAQ market should keep the proper listing standard level to maintain investor protection and market quality.