Vaasan yliopisto
UNIVERSITY OF VAASA

Anna Lehtinen

Post-Investment Information Asymmetry in Venture Capital Investing

Venture Capitalist's Legal Mitigation Strategies

School of Accounting and Finance
Research Paper in Financial Law
Master's Degree Programme in Business Law

Vaasa 2021

UNIVERSITY OF VAASA
School of Accounting and Finance
Author: Anna Lehtinen
Title of the Thesis: Post-investment Information Asymmetry in Venture Capital Investing: Venture Capitalist's Legal Mitigation Strategies
Degree: Master of Science in Economics and Business Administration
Programme: Master's Degree Programme in Business Law
Supervisor: Olli Välimäki
Year: 2021 **Pages:** 73

ABSTRACT:

During recent years, venture capital investing has become an established funding source with a crucial role in supporting economic growth by stimulating innovation. The venture capital industry has developed the tools needed in order to take on the challenging task of nurturing high-risk, promising new ideas but it is a business marked by uncertainty and gaps in the information sharing with their entrepreneurial contracting parties.

The information asymmetry is a major challenge for venture capital firms, as it makes it difficult to assess a firm and enables opportunistic behaviour by entrepreneurs after the financing has been received. Previous research has to a great extent focused on information asymmetry occurring prior to the investment decision, whereas this dissertation has explored the less researched topic of post-investment information asymmetry.

The purpose of the study is to identify, define and evaluate legal mitigation strategies succeeding the investment decision from the venture capitalist's point of view. The research findings are that the venture capitalist can through agent constraints, affiliation terms, appointment rights, decision rights and agent incentives as well as other contractual strategies mitigate post-investment risks. The analysis however shows that, while the implications of information asymmetry in venture capital investments are well understood, there are still no mechanism that can reduce the implications to a complete extent.

The main conclusion derived from the thesis is that a combination of different mitigation actions is the most efficient strategy to target post-investment risks. A combination would secure that all post-investment risks are addressed and would, at the same time, reduce the net value of the negative consequences that the shortfalls associated with each mechanism potentially causes.

KEYWORDS: Venture Capital, Information Asymmetry, Moral Hazard, Agency Cost, Risk Mitigation, Investor, Control, Legal

Contents

1 Introduction 7

1.1 Problem area 8

1.2 Purpose 9

1.3 Research question 10

1.4 Sources 10

1.5 Delimitations 10

1.6 Structure of the thesis 11

2 Venture Capital 14

2.1 The venture capital industry 15

2.2 The venture capital process 16

2.2.1 Establishing a fund 17

2.2.2 Deal flow 22

2.2.3 Investment decision 22

2.2.4 Value adding 24

2.2.5 Exit strategy 25

2.3 Venture capitalist-entrepreneur relationship 27

3 Information Asymmetry 30

3.1 The agency theory 30

3.2 Moral hazard 32

3.3 Other theories on information asymmetry 34

4 Information Asymmetry and the Venture Capitalist 36

4.1 Post-investment risks 37

4.1.1 Change in behaviour 38

4.1.2 Misaligned interests 39

4.1.3 Unequal distribution of information 40

4.1.4 Corporate risks 41

4.2 Risk management 42

5 Legal Strategies to Mitigate Information Asymmetry 45

5.1 Agent constraints 47
5.2 Affiliation terms 49
5.3 Appointment rights 52
5.4 Decision rights 54
5.5 Agent incentives 55
5.6 Other contractual strategies 57
5.6.1 Syndication agreement 58
5.6.2 Active involvement 59
6 Conclusions 62
6.1 Research findings 62
6.2 Contributions 64
6.3 Limitations 65
6.4 Suggestions for further research 65
References 67

Figures

Figure 1. The structure of the thesis 13

Figure 2. The venture capital process 17

Figure 3. The VC fund structure 19

Figure 4. Venture Capital Role in a Start-up’s Growth 21

Figure 5. Post-investment risks 38

Figure 6. Strategies for Protecting Principals 46

Figure 7. Legal mechanisms targeting post-investment risks 63

Definitions and abbreviations

Venture capitalist	Investor that acts as an intermediary between financial institutions and unquoted ventures. Invests a certain amount of money which makes them entitled to a share of the returns in the business.
Entrepreneur	Companies in which the venture capitalist invests
OYL	Osakeyhtiölaki 21.7.2006/624. The limited liability company law in Finland
AML	Arvopaperimarkkinalaki 14.12.2012/746. The securities market law in Finland
KPL	Kirjanpitolaki 30.12.1997/1336. The accounting law in Finland

1 Introduction

Young entrepreneurial firms in a swift growth phase are frequently met with the need to find financial assistance that exceeds their current resources and networks. Even though this can be considered as a good prospect for the business itself, the search for outside investment can be challenging. For firms with high growth expectations, venture capital funds may be the answer to the firm's capital needs. (Vinturella & Erickson, 2013). During recent years, venture capital investing has become an established funding source with a crucial role in supporting economic growth by stimulating innovation (FVCA).

In the first half of year 2020, The Finnish Venture Capital Association (FVCA) reported a record of 245 million euros of venture capital investments received for Finnish companies, out of which 145 million euros came from foreign investors and 100 million euros from Finnish investors. (FVCA). There was a prominent fear that COVID-19 would have a significant negative effect on the accumulation of capital funding for early stage investments, but a recent study shows that the Finnish start-up market is still able to circulate capital even to the extent that the outlook is more positive in year 2021 than it was the year before (FVCA).

In addition to providing entrepreneurial firms with capital, venture capitalists also provide their portfolio companies with non-monetary support in the form of expertise and network connections. Providing more than capital funding is necessary in order to be able to successfully co-invest with an entrepreneur and to get the company expanding (Isaksson, 2006). By these non-monetary contributions, venture capitalists can reduce risk as well as add value to the venture through their knowhow of specific industries, by financial and strategic planning as well as market development recruitment. (Gompers & Lerner, 2004).

The venture capital industry may have developed the tools needed in order to take on the challenging task of nurturing high-risk, promising new ideas but it is, however, a business marked by uncertainty and gaps in the information sharing with their contracting

parties. The information asymmetry is a major challenge for venture capital firms that invest in companies with a short history, often operating in new industries with a lack of historical data. (Gompers et al, 2009).

1.1 Problem area

Informational gaps, or asymmetries, make it difficult to assess a firm and it also enables opportunistic behaviour by entrepreneurs after the financing has been received (Gompers et al, 2009). Information asymmetry generates issues both for the entrepreneur, who do not want to be exploited, and for the venture capitalist, who is concerned with finding and funding quality deals. The implications of information asymmetry vary depending on the growth stage of the start-up, as well as the stage of the venture capital financing (Glücksman, 2020). To address the information asymmetry, venture capitalists engage in a variety of control mechanisms (Gompers et al, 2009).

Venture capital investing and the underlying information asymmetry has been of interest to researchers in the past decades. Theoretically, the agency theory that separates ownership from control (Jensen and Meckling, 1979) and information theory are often used when studying contracting issues in venture capital investing. Such theories suggest that entrepreneurs possess an informational advantage over the venture capitalist, generating risk of adverse selection as well as moral hazard (Cumming & Johan, 2014).

The risk for adverse selection is in general more present prior to the investment decision, where it primarily deals with issues of hidden information that could lead to poor investments. The risk for moral hazard focuses on the entrepreneur acting opportunistically to the venture capitalist’s disadvantage and is therefore present during the whole investment cycle. Both entrepreneurs and venture capitalists suffer from principal-agent conflict. Entrepreneurs tend to use information asymmetry opportunistically whereas the rational investor suffers the consequences. (Werner et al, 2016).

A screening of previous research shows that information asymmetry occurring before the investor makes the funding decision is a well-researched topic, where the mitigation actions are highly related to the screening process of due diligence that is performed prior to the investment. The imbalance that materializes after the investment has been made is, in contrast, more unexplored and will be emphasised in this paper.

Amit et al (1998) have examined why venture capital exists and state in their research that information asymmetry is the key to understanding the venture capital industry. Under their hypothesis, venture capitalists are financial intermediaries with a comparative advantage in working environments where informational asymmetries are prominent. (Amit et al, 1998). By identifying this conflict of interest and settling it through different mechanisms, long-term sustainability of the corporate performance can be achieved (Marcel et al, 2010).

1.2 Purpose

This paper approaches information asymmetry from the venture capitalist's perspective, that occurs when the investment has already been made. The purpose of the study is to identify, define and evaluate legal mitigation strategies, succeeding the investment decision.

By answering the set research question, the thesis intends to contribute to the academical field of a fairly new research area in Finland. The aim is also to provide management guidance in how to utilize legal mechanisms for targeting post-investment risks arising from informational imbalances.

1.3 Research question

This dissertation takes a critical perspective on the identified problem area, considering the purpose by reflecting and providing answers to the research question of:

> *How venture capitalists can, through legal strategies, mitigate post-investment risks related to information asymmetry arising from the relationship with the entrepreneur*

1.4 Sources

The core juridical question is centred around the possibilities to mitigate risks by legal structures and contracts, as well as the contractual freedom considering contract design.

The sources used in the thesis are both native and foreign research, articles as well as literature. The thesis focuses on the legal aspects, whereas the research aim is fulfilled under the Finnish legal system and its practices wherever possible. The area of venture capital falls primarily under dispositive law, meaning that the contracting parties themselves can decide how to operate efficiently in order to achieve their goals.

1.5 Delimitations

In this paper, informational asymmetry is considered a central characteristic in a venture capital investment. The information asymmetry is persistent both prior to the venture capitalist investment decision as well as after the investment decision has been made. This paper focuses however on the post-investment stage, where information asymmetry occurs after the investment decision has been made and the parties have entered into agreement with one another, thus excluding issues that are present prior to the investment decision, such as selection problems. From a theoretical standpoint, this means excluding adverse selection implications and solely focusing on those of moral hazard.

The main actors in a venture capital process are the investors, the venture capitalists and the entrepreneurs, where venture capitalists act as financial intermediaries (Amit et al, 1998). This thesis is limited to examine the relationship between the venture capitalists and the entrepreneurs, i.e. between the fund providers and the company in need of growth capital, and does not extend the analysis to investors. Delimitations have also occurred in the analysis of fund providers, as this thesis do not include other funding forms such as crowdfunding.

The problems of information asymmetry and the uncertainty in venture capital investing can also lead to issues in valuating young entrepreneurial firms and, also, in analysing whether venture capitalists are actually able to add value to their portfolio companies by their operations. These two valuation aspects are excluded from this thesis and the presumption that venture capitalists act as value adding business partners is only assumed but not confirmed in this research.

1.6 Structure of the thesis

This thesis takes a cross-functional approach to law and finance in order to examine legal mitigation actions for the venture capitalist related to information asymmetry, arising in relation to the entrepreneur after an investment decision has been made. Agency problems and legal strategies act as a foundation for the thesis.

Chapter two explores the concepts of venture capital, where the industry, process and internal organization is presented. The venture capital process is reviewed from entry to exit, where the chapter covers previous research related to the concept and sets the basis for exploring the venture capitalist’s relationship with the entrepreneur. This is fundamental for understanding the research, when moving into chapter three that provides the theoretical framework of information asymmetry. The theoretical framework begins with covering the agency theory, moving into the core problem of the research and

unfolding moral hazard and other theories that manages post-investment imbalances that generate risks for the venture capitalist.

After having established information asymmetry as a risk that venture capitalists undertake when investing in an entrepreneurial company, the post-investment implications of information asymmetry are examined in more detail in chapter four. The chapter identifies the post-investment risks that are central in the thesis. Chapter four ends with introducing the concept of risk management and setting the basis for the core of the research following in chapter five.

The chapter of legal strategies to mitigate information asymmetry screens actions that are at hand for the venture capitalist in order to reduce the negative impacts of risks that have been reviewed. A framework is introduced to explore the mitigation actions with enhancement from previous research as well as the Finnish legal system. Potential disadvantages with the mechanisms are also discussed.

Finally, in chapter six, the research is concluded by discussing the key findings, academical and managerial contributions, limitations as well as suggestions for further research.

The structure of the thesis could thus be summarized as follows in Figure 1.

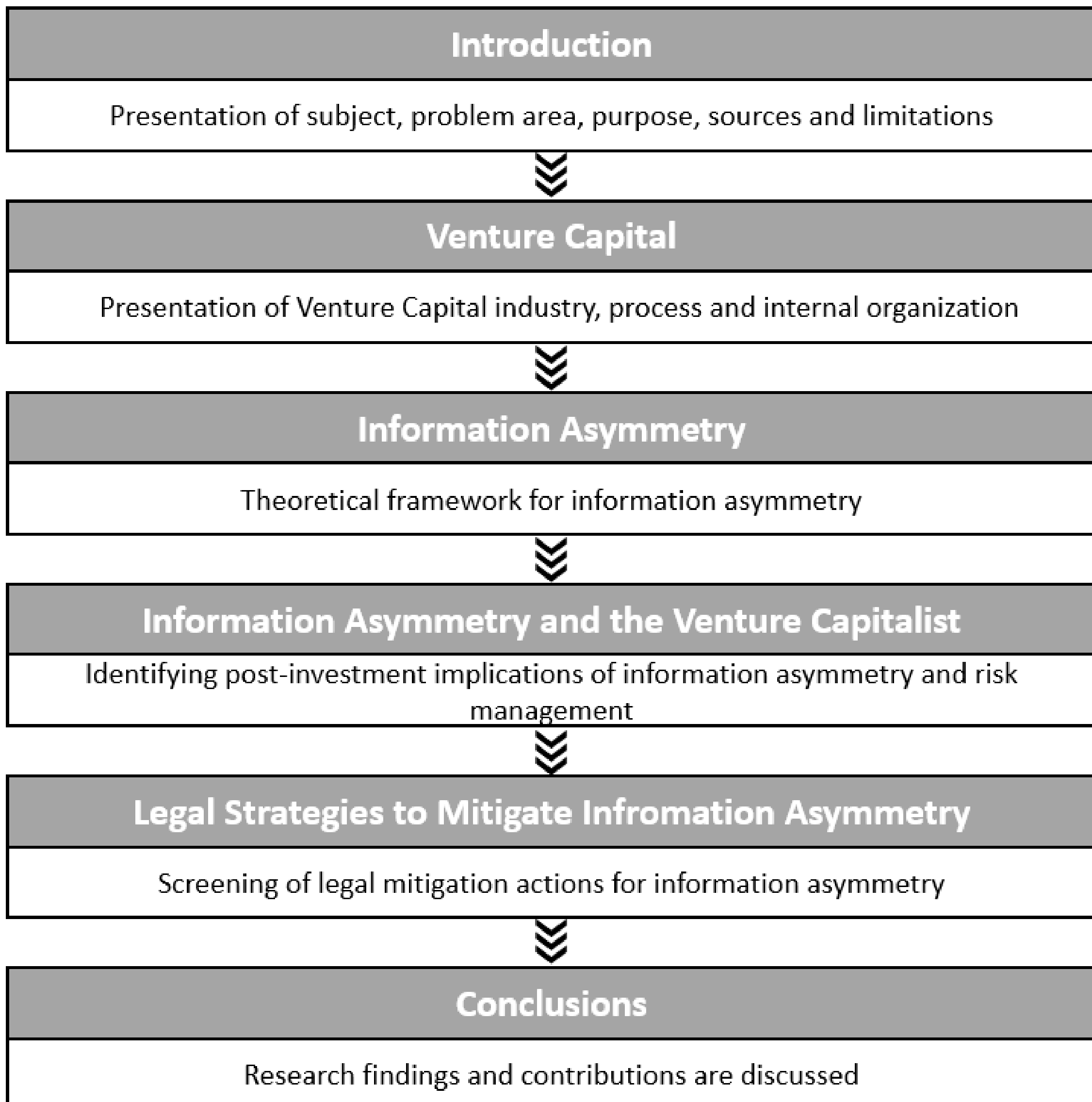

Figure 1: The structure of the thesis

2 Venture Capital

Venture capital financing refer to a form of equity financing, where stocks in unlisted companies are bought in exchange for a percentage of ownership. The two terms venture capital and private equity differ primarily in regards to the development stage of the company in which they invest, where venture funds are typically set up for earlier-stage firms (seed or start-ups) and private equity is broader in the sense that they also cover later-stage investments (FVCA). There is no univocal definition for venture capital funding, but venture capital funds are generally identified as financial intermediaries between sources of funds and high-growth entrepreneurial firms (Cumming and Johan, 2014).

The purpose of the investments is achieving a return on the invested capital on a long-term by developing their investee companies (FVCA). Venture capitalist activity has a significant impact on the global economies in terms of job creation, innovation and technology advancement (Gerken & Whittaker, 2014) and operate together with the entrepreneurs in accelerating companies' growth. Venture financing does thus not only mean money, but also knowhow, network connections as well as partnership. (FVCA).

Venture capital investors are on the look-out for growth companies that within three to five years have the potential to be market leaders within their industry. Above all, they look for high growth industries with large market potential and companies with strong management teams as well as unique business models. Venture capital firms invest relatively big amounts into the companies and intends the funds to be used for accelerating the growth of the company, that will later provide the expected return. (Vinturella & Erickson, 2013).

Venture capitalist provides the entrepreneur with equity or debt of hybrid forms of financing, in combination with their expertise (Amit et al, 1998). In exchange for the investment, the investor obtains a percentage of ownership in the company that is in proportion to the invested amount and involved risk (Vinturella & Erickson, 2013).

2.1 The venture capital industry

The first venture capital fund is traced back to 1946 (Lerner & Nanda, 2020) and, since then, successful companies like *Apple Computer, Microsoft* and *Intel* have been aided by venture capital investments during their early operating years (Vinturella & Erickson, 2013). The so called "dotcom-bubble" gave the venture capital market a boost during the early 2000's, which decreased due to the global financial crisis in 2008-2009. The market has again been able to recover (NVCA) and is signifying a positive outlook in Finland (FVCA) as noted in chapter 1.

The venture capital industry is recognized of being a subject to booms and downswings and of experiencing periodic investment cycles like other markets do (Gerken & Whittaker, 2014). The venture capital investing and the stock market developments are strongly interlinked, where Cumming (2014) puts forth that the nature of investments tends to vary with different cycles in the stock market as well as the initial public offering (IPO) market (Cumming & Johan, 2014). This phenomenon is prominent at the exit stage of an investment, where the venture capitalists harvest their primary revenues. In an economy with increased risk aversion and uncertainties, the stock market is unreceptive to IPOs. (Vinturella & Erickson, 2013). Sudden downturns that disrupt the plans of exiting an investment could also add to the pressure of selling when the market conditions permit, even if the growth opportunities are not fully realized (Lerner & Nanda, 2020).

Governments have as well a key position in influencing the growth of venture capital investing by creating new or modifying existing conditions (Armour et al, 2009). The venture capital industry in Finland has increased from the establishment of private venture capital funds, including captive funds established by banks. This is associated with an important regulatory change which since 1994 has permitted insurance companies to invest in venture capital funds. (Lumme et al, 2013).

2.2 The venture capital process

Venture capitalists invest in start-ups and growth companies (FVCA) at different development stages that all have their unique capital needs (Vinturella & Erickson, 2013). Lack of capital has been identified as a primary inhibitor to success, which is most prominent for young start-ups, that often lack adequate revenue during early operating years, as well as for rapidly growing companies (Vinturella & Erickson, 2013). Since growing with cash flow can be slow or even impossible, companies can with the aid from outside investors, such as venture capitalists, gain an advantage that continues to grow by the years (FVCA). Previous academic studies have shown that firms backed by venture capital funding are, on average, more successful in terms of innovativeness than firms that are not venture capital backed (Dessí & Yin, 2012).

A venture capitalists' primary activities are according to Ramsinghani (2014) three-folded; raising the venture fund, finding investment opportunities and generating financial returns (Ramsinghani, 2014). As illustrated in Figure 2, the venture capital process could be displayed by five different phases that are interlinked between each other due to the dynamic nature of venture capital investing (Isaksson, 2006).

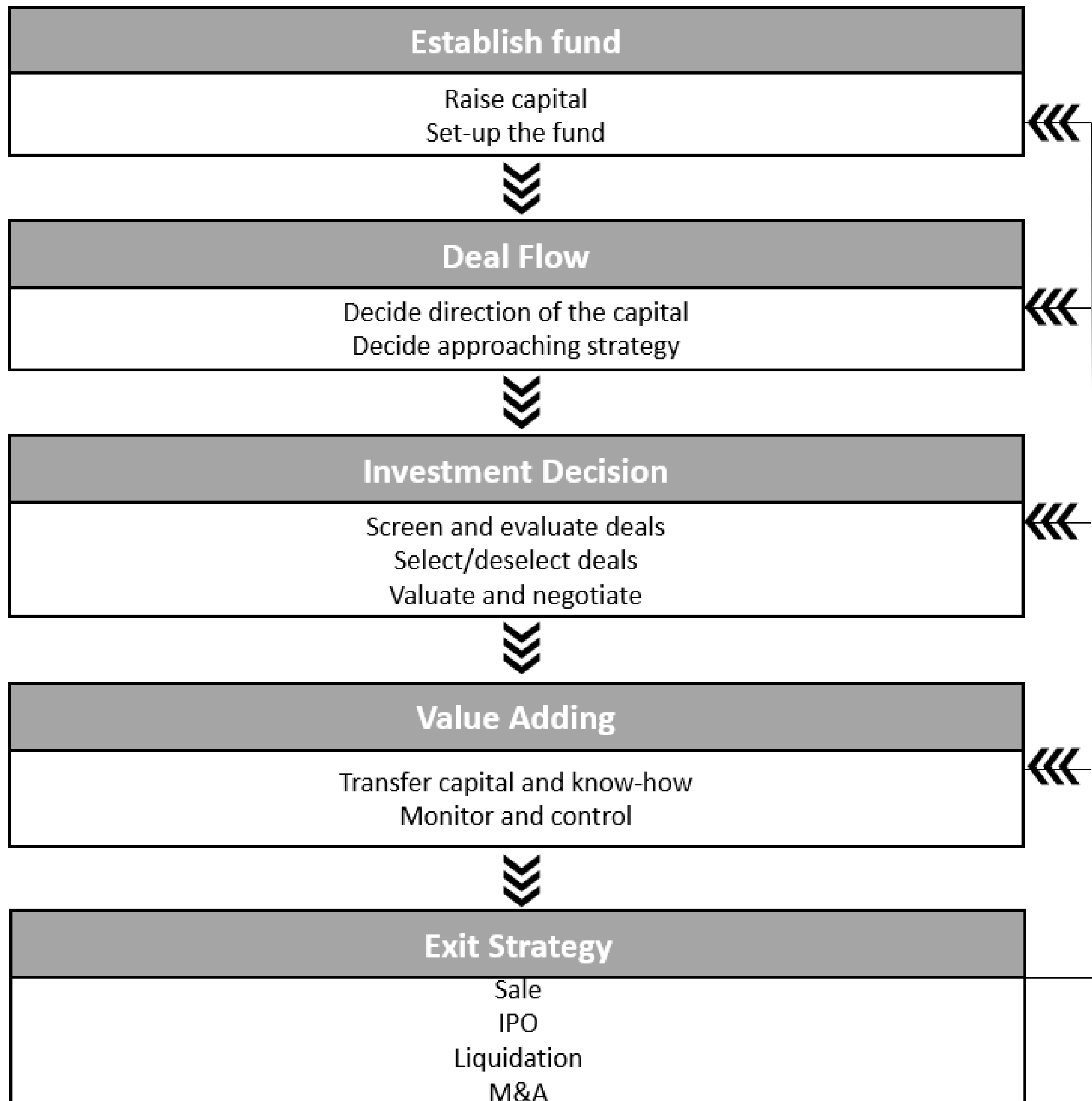

Figure 2: The Venture Capital Process (Isaksson, 2006)

2.2.1 Establishing a fund

The starting point for the investment process is establishing a fund from where the investments are made (Isaksson, 2006). Venture capital firms form a fund by raising investment capital from different institutions, or from high-net worth individuals, and use the capital to invest in companies with viable growth prospects (Vinturella & Erickson, 2013).

Venture funds are, in general, set up as limited partnerships, which constitutes a contract between investors, who become limited partners, and the fund manager that is responsible for the routine operations and management of the funds as a general partner (Cumming & Johan, 2014). Through limited partnerships, capital investments are made in a set-up by which the venture capital firm obtain a role as the general partner (Isaksson, 2006). Limited partnerships increase the firm's access to capital, providing growth opportunities for the target company that is not as limited as it could be in other organizational forms, such as general partnerships. It is common for a venture capital firm to set up new limited partnerships for each round of financing that the firm undertakes. (Vinturella & Erickson, 2013).

The fund manager is the one playing a significant role in building up the value of the target company by providing their expertise (Cumming & Johan, 2014). Limited partnerships are established and licensed under state law, where the limited partners provide capital but are not allowed to be involved in the daily operations of the business and they have limited liability exposure (Vinturella & Erickson, 2013).

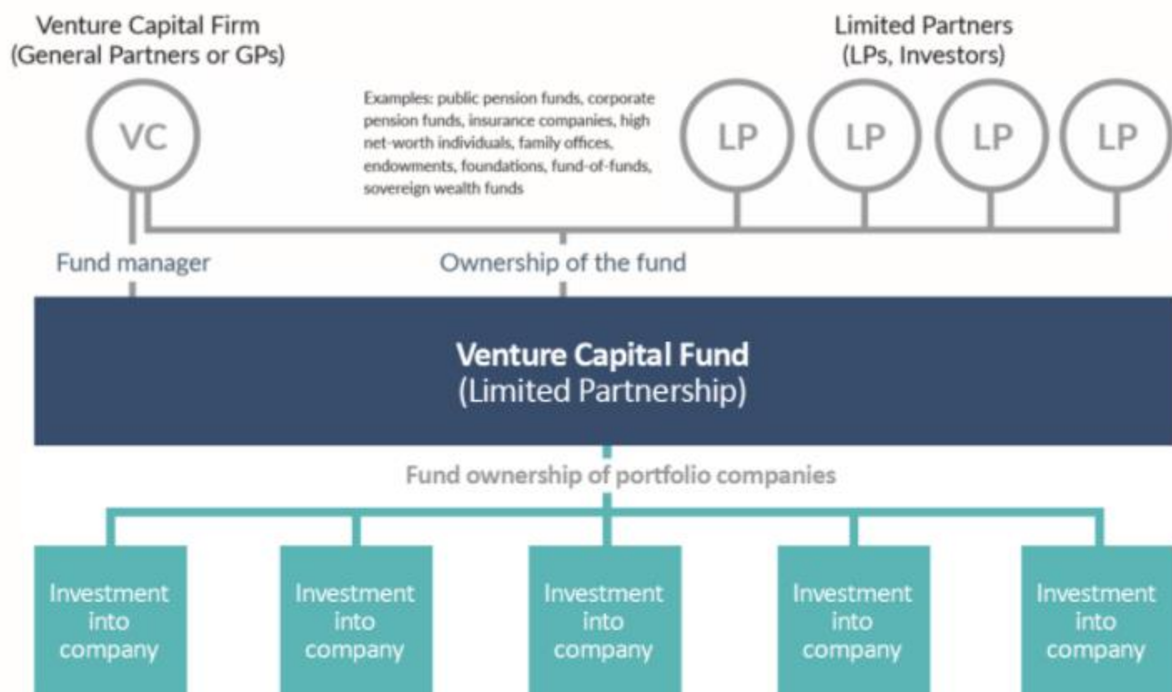

Figure 3: The VC Fund Structure (NVCA)

The funds that venture capitalists manage, also called investment portfolios, can range in size from a few million euros to billions of euros. The average life of a fund is set for a specific time period, usually of ten years, with new funds forming every couple of years that run alongside the existing funds. (Vinturella & Erickson, 2013; Cumming & Johan, 2014). There is a possibility to extend the length of the fund with one or two more years. Usually the venture capitalist has five years in which the capital is invested and are after that expected to use the remaining years of the fund to collect their investments. (Lerner & Nanda, 2020).

As with any other business model, venture capitalists need an investment strategy. This is usually executed by targeting a special set of investment opportunities (Isaksson, 2006). The funds that a venture capitalist manages are often directed toward companies in a certain growth-stage, different industries or toward specific geographical areas. (Vinturella & Erickson, 2013). The portfolio size of a fund varies between the industry and

the stage of investment. In technology sectors, the capital needs are lower, risks are deemed higher and growth rate of companies is faster. In comparison, life science companies have a larger capital need and need more time to reach maturation. Hence, a technology venture fund has, in general, more companies in its portfolio than life science funds. (Vinturella & Erickson, 2013).

The flexibility of funding is a central characteristic in the venture capital business model. Successful investors can maintain a portfolio of projects and reallocate resources from failing ventures to high-performing investments. (Bozkaya & Kerr, 2014). As new funds are forming continuously, successful firms do not wait until liquidation of the previous fund but raise their next fund as soon as most of the capital of the current fund is invested for existing portfolio companies (Ramsinghani, 2014). The number of funds that the venture capitalist manages can therefore vary between two to two dozen, and each portfolio company should indicate a potential to generate a return of 8 to 10 times the capital invested. (Ramsinghani, 2014).

Another parameter of a funding strategy is the development stage of the venture (Isaksson, 2006) which has a crucial role in the investment decision (FVCA). Figure 4 illustrates one way of categorising the different development stages that a growing firm passes. Venture capitalists often focus on a specific stage and investment size and adjust their equity stake accordingly. For example, investors investing in start-ups usually seek for a 10-30 percent stake of the company. (FVCA). Depending on the financing stage, the venture capitalist faces different types of risks that will need to be managed and monitored, and throughout the stages their involvement in the company will gradually decrease. The premise is that, while the relationship between the venture capitalist and entrepreneur prolongs and mutual trust is built, the need for control will decrease. (Caselli, 2018).

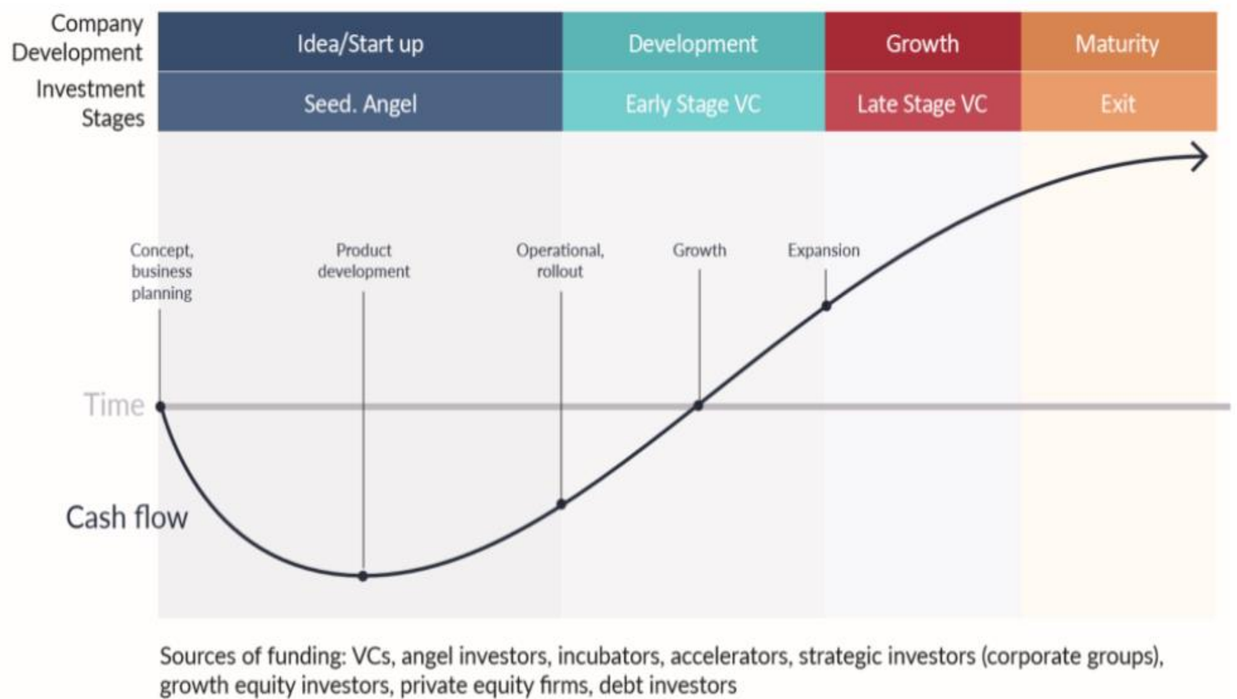

Figure 4: Venture Capital Role in a Startup's Growth (NVCA)

The goal of venture investments is solely financial in contrast to company subsidiaries, corporate venture capital firms, that primarily invest for strategic purposes. Corporate ventures invest the parent company money and do not utilize outside investor aid. (Vinturella & Erickson, 2013). Venture capitalists do not, generally, invest a lot of their own money, which distinguishes them also from what is known as angel investors (Gerken & Whittaker, 2014).

Early stage funding is typically used for product development and marketing funds, whereas later stage funding allows a firm to grow in a more rapid pace than retained earnings alone would allow. In a successful venture capital investment, the funded firm will reach the point where it can go public, allowing the venture capitalists to realize a return on their investment and exit the firm. Alternatively, venture capitalists can cash out by selling the firm to another company. (Vinturella & Erickson, 2013). The venture capital investment always ends with a divestment of the company, where the investors and owners hopefully receive the sought return (FVCA).

2.2.2 Deal flow

In this stage, the direction of the investment money is decided (Caselli, 2018). The approaches to discovering new venture opportunities could be divided into a proactive and reactive approach. A proactive venture capitalist actively seeks potential companies to invest in, whereas a reactive venture capitalist awaits business plan proposals to arrive to them. (Isaksson, 2006). In Europe, potential target companies are researched by the investor through direct marketing operations, making a leverage network an important element in finding deals (Caselli, 2018).

Venture capital investors are constantly on the lookout for companies with growth potential. Start-ups are seen more active to seek investment in comparison to growth companies. Growth companies may, however, begin the investment process themselves, by utilizing investment banks and advisors to find a suitable investor. (FVCA).

In order to spread the risks as well as broaden the range of opportunities and the knowledge base (Isaksson, 2006) the venture capitalist might use syndication, which is a coordinated investment between two or more venture capitalists (Amit et al, 1998). Syndication is argued to enable better decision making as to whether to invest or not as well as supports the cooperation in company valuation at an exit stage (Cumming & Johan, 2014). With syndication it is also possible to mitigate informational asymmetries (Amit et al, 1998), that for example generate agency problems such as hold up (Cumming & Johan, 2014).

2.2.3 Investment decision

Venture capitalists look for strong management teams and eccentric business models, and it is said that for every hundred plans that reaches a venture capital firm, approximately ten will be seriously considered and only one will be funded. (Vinturella & Erickson, 2013). Without strong credentials, many firms will not even be considered

(Cumming & Johan, 2014) as venture capitalists usually are cautious to invest without sufficient evidence on a company's growth potential.

For companies that make the cut in the screening process, due diligence is often the starting point for the investment process. The fund manager usually wants an in-depth analysis of the venture and brings in external consultants to review the technology and gain legal and financial advice. Prior to the due diligence process, a term sheet is drafted by the fund manager which contains the knowledge of the deal at that time and sets out the general terms and conditions of the investment. (Cumming & Johan, 2014).

Determining the current and future value of the firm is an important step in the negotiation process. One feasible approach to the financing is to project the company's future capital needs in terms of growth stage, each marked by individual capital requirements and measurable milestones. Common milestones in a seed company could for example be the completion of a prototype or a first sale. Predicting the future is risky and since the venture investments are based on future results, there is a risk that entrepreneurs are overly optimistic in their projections. Investors therefore want to receive realistic and meaningful financial forecasts from the target companies and expect the entrepreneurs to demonstrate an in-depth understanding of their operating market through its business plan. (Vinturella & Erickson, 2013).

The business plan projections are based on financial statements, where sales, expenses and assets are of interest, along with a demonstration of the market of the products (Vinturella & Erickson, 2013). In some cases, the target company does not have a reporting system in place that is able to support the investor in following up and monitoring the results. As this is vital for the quality of the company's administration and management, a functioning reporting system is something that the venture capitalist could be seeking to establish after investing. (FVCA).

Venture capitalists invest with the expectations of the funds to be used for accelerating the growth of the company sufficiently to provide the expected return, since the future return on investment is tied to the performance of the company (Vinturella & Erickson, 2013). The fund returns are measured by internal rate of return (IRR) and are a function the two factors time and capital. In order to obtain a high IRR, the portfolio company should be sold as fast as possible for as high an amount as possible. (Ramsinghani, 2014). Many venture capitalists set targets for their desired rate of return on their set of investments, which can be between 25-40 percent (Reid, 1998).

There are thus several implications arising already prior to the actual investment decision, that could lead to informational asymmetries between the parties. As will be covered later, these scenarios arising prior to the investment decision are generally referred to as adverse selection and are not at the core of this thesis. However, if they exist prior to the investment they will likely generate moral hazard issues lasting throughout the inter-contractual period.

Nonetheless, at the core of the venture capital investment is the transfer of capital and competence from the venture capitalist to the entrepreneurial firm. Conveying the capital is the final ending of the investment decision (even though it is rare that all capital is transferred at once) whereas transferring competence is done in the value adding phase. (Isaksson, 2006).

2.2.4 Value adding

Venture capitalists play a crucial role in enhancing the value of the target firm by speeding up the professionalization (Vinturella & Erickson, 2013) by providing non-financial assistance to their portfolio companies (De Clerq & Manigart, 2007). Aside from the financial support, venture capitalists help build the internal organization of the company, by providing administrative, marketing and strategic advice as well as a network consisting of for example lawyers, investment bankers and other industry operators. (Cumming & Johan, 2014; Vinturella & Erickson, 2013). Investors usually have a vast experience and

knowhow of both pitfalls and keys to growth through having invested in large groups of growth companies. Venture capitalists often bring with them a professional governance model to a company's board of directors, to secure the pre-requisites for later acquisitions or IPOs. (FVCA). If a venture capitalist chooses to syndicate their investments, syndications have the potential to strengthen the value enhancement, as they enable collaboration and knowledge sharing to an investment that possess informational imbalances (Caselli, 2018).

Managing and monitoring is a part of the venture capital process. These factors are in place to ensure the value creation of the company and to control potential opportunistic behaviour by the entrepreneur. (Caselli, 2018). The venture capitalist activity level in the portfolio company is dependent on the strategy of the investor as well as the stage of the investment. An active venture capitalist can transfer their resources and competences by for example active governance, where they participate in the board of directors or helping with leveraging the network. (Isaksson, 2006). The active involvement is also a key strategy in mitigating information asymmetry (Amit et al, 1998). The venture capitalist could for example in this phase stage their financing in order to control such risks (Tennert et al, 2018).

As previously noted, the duration of a venture capital investment will vary depending on the company prerequisites. Scholars have argued that venture capitalists will continue to invest in a firm if the provided marginal value added exceeds the marginal cost of maintaining the investment. Hence, ceteris paribus, the investment duration would be longer in a situation where the value added is greater. As the portfolio companies seldom have cash flow to pay interests on debt or equity dividends, venture capitalists primarily invest for the capital gains of an exit. (Cumming & Johan, 2014).

2.2.5 Exit strategy

A successful venture capital investment always ends in an exit, which is a detachment from the company (FVCA) and is the primary securement for the investor to obtain a

positive return on their initial investment (Vinturella & Erickson, 2013). Even though exit strategies are placed as the last part of the process, they are considered throughout the investment period (Isaksson, 2006) as the exit strategy is defined as the method by which investors can realize a tangible return on the investment (Vinturella & Erickson, 2013). In this last step, the venture capitalist sells their stake to not only gain the value added by the monetary investment, but also the return on the conducted management and control (Caselli, 2018). The exist stage is further a mechanism for mitigating consequences of information asymmetry, as will later be covered, as it provides the venture capitalist with the possibility to dissociate from opportunistic entrepreneurs (Armour et al, 2009).

The commitment of capital is dependent on whether the investor will recover their initial investment with addition of a profit. Converting the investor's ownership into a liquid form is referred to as a liquidity event (Vinturella & Erickson, 2013), that usually takes the form of an IPO or of an acquisition (FVCA). In an IPO, the stocks of the company are offered to the public and the company can, in addition to selling old stocks, also raise new capital by issuing shares. Acquisition means selling a company to another company, a new investor or to management. (FVCA).

Other exit strategies include secondary sales, buyback and forced liquidation of the company. In a secondary sale the venture capital firm sells only their part of venture shares to a third party, which thereby differ from an acquisition where the whole company is put to sale. The third party is often another financial institution or another venture capitalist and would, from an informational asymmetric point of view, put the second-round investor in the same situation as the first-round investor has been. In a buyback, the entrepreneur buys out the venture capitalist by a repurchase of the venture capitalist's shares. If a buyback occurs, it has usually been an item already at the contracting stage and included in the exit clauses. Liquidation cases can be seen as the worst-case scenario, where the company is forced into bankruptcy and liquidation if the venture fails. (Isaksson, 2006).

In a study conducted by Cumming (2006) it was shown that IPOs are more frequent in countries with a higher legality index. Previous research has further put forth that the choice between IPO and acquisition is highly influenced by the stock market, in hot markets IPOs dominate and acquisitions are more common in down markets. Typically, when the market conditions allow, the returns are higher in an IPO than in an M&A. Management buyouts require cash from the operations of the business, and are therefore mostly occurring in ventures that are consistently able to generate strong positive cash flows. (Vinturella & Erickson, 2013). Nevertheless, Cumming (2006) argue that the legal system in a country is more directly connected to IPO exits compared to the size of a country's stock market. (Cumming, 2006).

Investors are often more anxious than the entrepreneur to exit from the venture, as the entrepreneurs are more focused on building long-term value achieved by raising capital for the launch and expansion of their business, and may not even want to exit the firm at all. To the entrepreneur's potential distress, an exit opportunity could be presented through an acquisition by another company, where the entrepreneur may be forced to buy out the investors or lose control of the company. (Vinturella & Erickson, 2013).

Previous research has also shown that some venture capitalists seek a premature IPOs in order to obtain reputation and report on an increased performance (De Clerq & Manigart, 2007). In practice, a speedy exit can be problematic due to clashes with market conditions, and normally the exit horizons are six to eight years. (Ramsinghani, 2014).

2.3 Venture capitalist-entrepreneur relationship

The premises for venture capital investing are usually that the deal would end up benefiting both parties, since the actors would have the same interests at heart (FVCA). The main actors in a venture capital process could be divided into a supply side and a demand side. On the supply side are the investors, i.e. the fund providers, and the venture capitalists. The entrepreneurs constitute the demand side. The venture capitalists act as

financial intermediaries between the investors and the entrepreneurial firms that re in need of capital. (Cumming & Johan, 2014).

The relationship between the supply and the demand side is both contractual and reciprocal with a foundation in mutual trust. If one of the actors breaks the trust, it affects the relationship negatively (Isaksson, 2006). As will be concluded in the next chapter, this sets the basis for an agency relationship which arise whenever a relationship is formed between economic actors, where the welfare of one party depends on the actions of the other (Marcel et al, 2010). The sharing of ownership and control between the parties is often the factor that causes implications in the relationship (Isaksson, 2006) and sets the stage for information asymmetry (Cumming & Johan, 2014).

The venture capitalist wants to seal a deal with an entrepreneur in order to potentially hit a profitable investment opportunity and find a unique skill- or knowledge-sharing arrangement, where ownership and control is shared. The entrepreneur's interest to enter a contract with a venture capitalist, on the other hand, lies in gaining additional equity-based funding, spreading the risk by involving the investor in the daily business operations and accessing an expanded network (Cumming & Johan, 2014; Werner et al, 2016). During the investment, the entrepreneur usually gives up some of the ownership in the company with the hopes that the company will grow such that the remaining ownership is worth more than the original stake when an exit point is reached. (FVCA).

In general, private equity investors are motivated by an aptitude for high-risk. In a venture capital investment, potentially high remuneration is supporting the high-risk initiatives, but the realization of operations is still a challenging task (Caselli, 2018). Since venture capitalists are familiar with high-risk investments, they have been argued to be able to mitigate information asymmetry by using their skills (Reid, 1998).

There is a correlation between the firm's ability to access different capital sources and the degree of information asymmetry faced by their investors as well as their ability to

mitigate such information asymmetry. Information asymmetry is grounded in the entrepreneur knowing more about the business than an external investor, which is both a risk and a cost to the investor. (Cumming & Johan, 2014). The asymmetry creates an unequal balance in power that the venture capitalist needs to monitor and control. If control mechanisms are missing, then entrepreneur opportunism is a likely consequence that leaves the venture capitalist clueless on where the provided financing is used (Caselli, 2018).

3 Information Asymmetry

In perfect capital markets, all actors have access to the same information at the same time. Conventionally put, the buyer and the seller of goods are, in perfect capital markets, presumed to have the same information about the goods being sold (Hillier, 1997). Realistically though, one counterparty in a business transaction often possess an information advantage over the other one and the information is shared unequally (Glücskman, 2020), giving rise to information asymmetry. Irrespectively of the contracting parties' relationship, interaction and sources of information in a financial transaction, there is an informational imbalance that could give rise to conflicts of interest (Välimäki, 2014).

The dilemma of information asymmetry in economic settings is usually illustrated with an agent, on one side of the contract, that possess an informational upper hand on the counterparty of the principal. Referring to the example of the seller and the buyer of goods, the seller as an agent usually has more information about the qualities of the goods, compared to the potential buyer that is here considered as a principal. (Hillier, 1997).

When the counterparties do not have access to the same information at the same point of time, the parties will inevitably have different behaviours that could have an impact on the performance of the company. Thus, within the theory of information asymmetry, the information that parties hold and the decision they can take based on that is of crucial importance. (Marcel et al, 2010).

3.1 The agency theory

The problems of a principal-agent relationship arise when a principal hires an agent under conditions of ambiguous and asymmetric information (Cumming & Johan, 2014). At the core of agency theory is hence a relationship much like a contract (Caselli, 2018). Under the assumption that people seek to utility maximize own interests, the agent is

presumed to behave against the best interests of the principal, which in turn affect the principal's financial returns. (Cumming & Johan, 2014). The central implication is that due to the agent frequently having an informational upper hand on the principal about relevant facts, the principal cannot verify that the agent's actions are aligned with the shared goals or what was agreed. Thereby, the agent is incentivized to act opportunistically and minimize the effort that is put in which affects the value. To prevent this, the principal has to engage in costly monitoring processes. (Armour et al, 2009).

The agency theory model is highly dependent on how the information flows between the agent and the principal (Reid, 1998). Since it is impossible to continually monitor the activities of the other party, the agent can act in contradiction with the interests of the principal. By contract design, incentives can be implemented to steer the agent to work toward the common goals. Many actions by the agent are however observable but not verifiable, which makes it impossible to design a contract that anticipates and addresses all possible scenarios and thus the agency problem will prevail to some extent. Even though all eventualities cannot be foreseen, anticipated agency problems can be addressed while mitigating the capacity for other agency problems to develop. (Cumming & Johan, 2014).

Information asymmetry cannot however be solved solely by information but requires a consideration also of the agent's control over the firm's accounting systems. Accounting provides financial measurements in the form of inputs and outcomes, which is a vital part of the flow. Accounting information both for driving investment decisions and for assessing the performance. (Reid, 1998).

Costs that arise from the conflict of interest where the agent does not act in the best interest of the principal are referred to as agency costs. The term refers to activities that one contracting party may do, that are of self-interest and against the interests of the other contracting party (Cumming & Johan, 2014). Agency costs can take a multifaceted form. For example, the agent may shirk their job responsibilities if their effort is not

verifiable or may keep a loss-making project going if they see a chance to act opportunistically. (Wang & Zhou, 2004). Jensen and Meckling (1976) have addressed the realization of agency costs that arise from the information asymmetry between contracting parties in their influential article of Agency Theory, which separates ownership from control within ownership corporations (Jensen and Meckling, 1976).

According to Jensen and Meckling (1976) a commitment between one or more principals and an agent, where the principal engages the agent to execute service on their behalf constitutes an agency relationship. The conducted performance involves delegation of decision-making power, which can cause a conflict of interest if the agent pursues maximizing own interests, and thereby not act in the best interest of the principal. The principal can limit the conflict of interest by agency costs, which is an establishment of payment incentives for the agent, or by incurring monitoring costs that limit undesirable actions from the agent. (Jensen and Meckling, 1976).

The agency theory argues that venture capital investments constitute complicated agreements where specific clauses must be worked out in order to realize a deal (Caselli, 2018). Other corporate governance scholars claim that the conflict of interest arise as the incentives of managers are not fully aligned with those of their institutions, and have traditionally focused on the topics of reducing top-management conflicts of interest and of improving board governance (Sun et al, 2011).

3.2 Moral hazard

One form of information asymmetry is a moral hazard-circumstance, which is often occurring in economic activities and refer to agency problems that may arise in a form of hidden actions after the contract is sealed and entered between a principal and an agent (Cumming & Johan, 2014). Moral hazard was first introduced in insurance markets, where insured parties can undertake actions to either decrease or increase risks. Even though moral hazard-implications can arise in any economic activity and investment environment, they are especially crucial in entrepreneurial finance. (Amit et al, 1998).

Kotowitz (1989) define moral hazard as actions in economical transactions, where the agent utility maximizes his/her own interests at the expense of the principal. After the contracting stage, a principal-agent relationship exists between the venture capitalist and the entrepreneur. The venture capitalist is the principal in the relationship and the entrepreneur the agent, where the principal is put in a position of addressing moral hazard implications. (Kotowitz, 1989).

These situations often occur where the utility maximizing agent do not bear the full consequences, or benefits, of their actions. Moral hazard originates in a control issue where the agent's actions are perceptible, but not the information on which they are based, (Kotowitz, 1989) which in turn makes the agent's efforts unobservable (Mishra & Zachary, 2015) and legally unverifiable (Amit et al, 1998). The entrepreneur might thus not provide the desired level of effort and may choose not to conduct tasks that maximizes the investor's return (Mishra & Zachary, 2015). The agent also often has access to information that is not available to the principal unless the agent shares the information (De Clerq & Manigart, 2007). In practice, the agent can withhold information from the principal or put in minimal effort, which affects the expected payoffs of the principal negatively.

The entrepreneurs are motivated to act in self-interest, even if it means imposing costs on the other party (Amit et al, 1998), by consuming the perks and putting in minimal effort in their actions (Reid, 1998). They have the potential advantage of obtaining full benefits but only bearing a proportion of the costs. The principal therefore wants to agree on decreasing the effects of moral hazard, which can be done either in a positive or negative sense. The principal can put up bounding, through which penalties are imposed on the investor if certain milestones are not met or, more positively, also establish incentives through which the agent is rewarded for meeting certain milestones. (Reid, 1998).

The principal may also attempt to influence the agent by monitoring the performance. Monitoring refers to mechanisms that the venture capitalist uses to evaluate the entrepreneur's behaviour and performance in order to keep track of the investment (De Clerq & Manigart, 2007). Since a direct observation of the agent's actions is impractical, the performance is measured by the results of the agent's actions (Reid, 1998). The principal often has strong incentives to monitor the agent's actions, as the interests of the parties are not always aligned (De Clerq & Manigart, 2007).

The negative aspects of monitoring are two-fold, firstly it is difficult for a principal to distinguish what the agent is doing in good faith and what is the effort and intent behind. Secondly, the agent possesses more knowledge over the business operations compared to the principal, whereas there is an imbalance of information. The agent may also provide information selectively, in order to show outcomes as more favourable than they are in reality. (Reid, 1998).

3.3 Other theories on information asymmetry

Another phenomenon of information asymmetry is called a *hold-up* situation. These are circumstances where there is unequal bargaining power between contracting parties, where the contracting party with a stronger bargaining power may "hold up" the other party and renegotiate the terms of the original contract. In a venture capital scenery, the investor could provide the entrepreneur with a large amount of capital, but it would be the entrepreneur who can ensure the success of the venture and thus have the power to renegotiate the investment terms. (Cumming & Johan, 2014).

Window dressing, on the other hand, refers to making something look as good as possible on the outside relative to what is the reality. This could mean that entrepreneurs have an interest in making their firm look as good as possible on the outside to secure the next financing round from their investor. Therefore, entrepreneurs may have the incentive to exaggerate projected sales or anything else that convinces the venture capitalist to continue investing in the firm, putting the venture capitalist at great accounting

risks. Typically, the short-term benefits from window dressing are inferior to the long-term costs that it causes. (Cumming & Johan, 2014).

The entrepreneur having an informational advantage about the prospects of the firm could also generate a possibility for the entrepreneur to communicate the standpoint of the firm to something else than what it is to the investor, while misusing the firm's assets. This is referred to as *asset stripping*. Later in a potential bankruptcy, the stripping of assets is difficult to prove. (Cumming & Johan, 2014).

If the venture would be financed with debt capital, the entrepreneur has an incentive to conduct *risk shifting,* by increasing the risk profile of the firm which would transfer the expected prosperity from the investor to the entrepreneur. (Cumming & Johan, 2014).

4 Information Asymmetry and the Venture Capitalist

The information asymmetry is a vital issue in the venture capital financing and often leads to agency problems that arise due to either hidden information or hidden actions from the other party. Hidden information surfaces when one party is in possession of relevant information that is unknown to the other party which is known as an adverse selection status, that is often present prior to the contracting stage where the entrepreneur has an upper hand in knowing their business. Hidden actions, on the other hand, are present in the stage that follows the investment and is known as a moral hazard stage. Moral hazard is marked by an uncertainty of the entrepreneur's actions, which the venture capitalist cannot observe. Such a case could for example be that the entrepreneur does not spend the invested capital accordingly with the interest of the venture capitalist. (Glücksman, 2020).

Venture capital funds are often directed toward entrepreneurial firms with significant information asymmetries, as the funded firm usually does not have a lengthy operating history (Cumming and Johan, 2014) and it has a significant amount of intangible assets (Amit et al, 1998). Since entrepreneurial firms lack assets to provide as securities and also lack the necessary track record to establish a reputation, the effects of informational market failures are more severe in entrepreneurial finance than in financing established firms. Such market failures could lead to profitable projects being unfunded or underfunded. The more skilled a venture capitalist is in reducing the sources of market failure, the more effective is the functioning. (Amit et al, 1998).

The moral hazard dilemma that was reviewed in the previous chapter is prominent in venture capital investing (Glücksman, 2020). According to Kotowitz (1989), the moral hazard dilemma occurs after the contracting stage when the venture capitalist fears that the entrepreneur is acting opportunistically and only utility maximizing own interests at the expense of the investor and/or hiding essential information. Because of the information asymmetry, the investor sees a need to monitor the actions and decision making

of the entrepreneur, thus creating agency costs. (Kotowitz, 1989). The empirical significance of monitoring is supported by previous research, such as Lerner (1994).

In the context of this paper, the venture capitalist is considered as a principal and the entrepreneur as an agent. Many of the operations performed by venture capitalists involves agency costs (Cumming and Johan, 2014), which emerge when the entrepreneur sees to utility maximize the resources to own gains, instead of considering the interests of the investor. The entrepreneurs are, in general, considered to have more insight in their company and its daily operations (Glücksman, 2020) which they could be reluctant to share with the venture capitalist (Werner et al, 2016).

It is important for the venture capitalist to know which uncertainties they want to mitigate and which the pain points are that causes information asymmetry. Following, risks related to the post-investment stage will be identified.

4.1 Post-investment risks

As has been stated, a crucial problem in the venture capital business is the information asymmetry between the entrepreneurs and capital providers (Glücksman, 2020). Conflicts may arise already at the investment stage due to misaligned expectations between the venture capitalists and the entrepreneur's future roles. Since the roles are subject to contracts, the initial contract is seen as a basis for a successful co-operation. (Isaksson, 2006).

After the initial investment has been made, managing the portfolio companies contains information asymmetrical risks to the venture capitalist, as the entrepreneurial opportunism can take the form of differing goals, changes in behaviour and an unequal distribution of essential information. There are also risks associated directly with young firms that may cause information asymmetry toward the venture capitalists, without direct actions from the entrepreneur. (Vinturella & Erickson, 2013).

Post-investment risks due to:

Actions of the Agent	Nature of the Company
Change in behaviour Misaligned interests Unequal distribution of information	Corporate risks

Figure 5: Post-investment risks

4.1.1 Change in behaviour

A key characteristic of a principal-agent relationship is that the agent has an incentive to decrease effort and to avoid risk (Reid, 1998). The principal is looking for signing a contract that will give incentives to optimize effort and share the risk. Both parties are expected to be looking for utility maximizing their own interests, where the venture capitalist experiences utility as a net effect of the payoff less what the agent is paid, whereas the entrepreneur experiences utility as positively dependent on the received payment less their own efforts. (Reid, 1998).

Change in behaviour is a prominent risk of human aspects in the venture capital business, as the personal attitude of the entrepreneur could change negatively after they have received the capital funding. The entrepreneur could be neglecting and unwilling to make efforts that meet the common goals and interests with the venture capitalist. (Bigus, 2002). This potential lack of commitment is a risk that the investor wants to avoid, as it puts the effectiveness of the company at risk (Caselli, 2018).

As earlier mentioned, the venture capitalist often seeks a board position which would indicate attending board meetings. However, if the venture capitalist does not attend board gatherings or otherwise in the strategic decision-making, the entrepreneur is able to act out of sight of the investor to own benefits, creating moral hazard. If the agent can act out of sight of the investor, then it is also possible that he or she can claim high effort without actually having made it if a profitable outcome arises. (Reid, 1998). Since effort

is only potentially observable, not verifiable, the agent cannot be forced to put in effort. It is, however, possible to incentivize effort. (Cumming & Johan, 2014).

It has been showed that lower degrees of ownership increase the likelihood of the entrepreneur to act opportunistically (Bellavitis et al, 2019). After the investment, the entrepreneur owns less than one hundred percent equity in the venture. By giving up some equity to the investor, the entrepreneur shares the results of efforts with the investor, where the entrepreneurial effort will then be proportional to her percentage of equity in the venture and inversely proportional to the investor's percentage of equity. (Mishra & Zachary, 2015).

The moral hazard implications arise as the entrepreneur can act out of sight of the investor, and therefore have the possibility to claim high effort without having done anything to support a profitable outcome (Reid, 1998). The entrepreneur could thereby not exert the same level of effort as would have, if the ownership in the venture was one hundred percent. The more equity that is given to the investor, the less will be the effort and desire for the entrepreneur to maximize the investor's return. This puts forth a need for the venture capitalist to exercise control (Mishra & Zachary, 2015) that, in turn, generates agency costs.

4.1.2 Misaligned interests

One of the most common issues are the different values and goals between the investor and the entrepreneur. Entrepreneurs place a high value on financial returns, but are at the same time interested in autonomy, control and in creating a successful new business. Thus, they may be hesitant toward a quick exit or to undertake actions that weakens their ownership in the company. (Bodde & John, 2012; Werner et al, 2016). The implications occur if the agent begins serving interests that are misaligned with the investors, such as their own. Conflicts thus take place when the contracting parties have either different motivations or if incentives are implemented that place the parties on opposite sides of each other. (Armour et al, 2009).

Even though the parties are initially aligned on values and goals, this might change during the process. A powerful and immediate way of exercising influence is for the investor to possess government by obtaining a board seat (Bodde & John, 2012), which the venture capitalist usually wants and seeks (FVCA) in order to be able to monitor the business activities and the business development. Investors are, in general, more focused on the exit phase than the entrepreneurs, who tend to focus on enhancing the long-term value of the company. (Vinturella & Erickson, 2013).

The entrepreneur could act in a way that prioritizes own wealth over the company's welfare or keeping the business operational, even though it is not beneficial for the venture capitalist. This will likely affect the company's operations and decision making negatively and lead to an incorrect valuation at a later stage and therefore needs proper control. (De Clerq & Manigart, 2007). The disagreements in the value creation are complicated for the venture capitalist, as it has a direct impact on the investment's IRR (Caselli, 2018).

Misaligned interest can also lead to a hold-up situation, where the entrepreneur benefits from their bargaining power. As has been mentioned, it is the entrepreneur who at the end could ensure the success of the venture but could also in a disagreement with the investor threaten to leave the organization. (Cumming & Johan, 2014).

A further risk for the venture capitalist is if the entrepreneur brings in a new shareholder (Caselli, 2018). In non-syndicated ventures, the entrepreneur could, if in control, sell the right of control further to a third party in the threat of a possible bankruptcy. This transaction could harm the initial investor as it did not invest in the firm to have decision made by an unknown new investor that could steer the business toward undesired directions. (Cumming & Johan, 2014).

4.1.3 Unequal distribution of information

Moral hazard stems from the entrepreneur both being the controlling officer and possessing as well as accessing inside information about the company that is not available

to the venture capitalist. Entrepreneurs have been shown tendencies to resist sharing information with the venture capitalists, as it could lead to them obtaining too much influence in the company. (Werner et al, 2016).

After receiving the investment, the entrepreneur could use the information asymmetry to their benefit by for example misinforming or misleading the investor (Huang et al, 2015). In practice, the entrepreneur could hide the actual status and business progress. The degree of uncertainty to which entrepreneurs will withhold relevant information and pursue own interests is referred to as agency risks. (Cumming & Johan, 2014). The consequences of either misinforming or misleading the investor are especially prominent if the parties operate with a geographical distance between them, as it decreases the venture capitalist's control over the entrepreneur's actions by making monitoring harder to accomplish (Huang et al, 2015). As earlier noted, the entrepreneur could also mislead the investor by window dressing the financial statements, making the company performance look better than what it is (Cumming & Johan, 2014).

The venture capitalist has a fiduciary responsibility to ensure that the capital invested is used for the purposes intended and that all actors are focused on the principal goal of obtaining satisfactory a return on their investment. Under moral hazard circumstances, the entrepreneur has an incentive to overstate business prospects if they do not trust the venture capitalist to provide further financing if the forecasts or targets are not met. (Gerken & Whittaker, 2014).

4.1.4 Corporate risks

The venture capitalist faces risk, where there is a possibility of losing the investment. The venture investments could be categorized as speculative risks, where the investors face both the possibility of gain but also the possibility of loss. What distinguishes speculative risks from other risks is that speculative risks only exist after an individual has acted upon a decision that has been made with the possible gain in mind. There are also risks that could lead to information asymmetrical implications without the direct actions of the

entrepreneur or an opportunistic behaviour. Entrepreneur opportunism could also arise when the entrepreneur acts in good faith, if the entrepreneur has minor business experience and lacks the ability to run the company as it grows, which could result in mismanaging the invested capital. (Vinturella & Erickson, 2013).

Venture capital is connected to great risk due to a variety of factors stemming from the portfolio companies being naturally more open to higher total risk than more developed corporations (Werner et al, 2016). There might be limited knowledge about the market and the future customers as well as a high uncertainty about the level of potential success, which leads to a distinctive problem between the entrepreneurs and venture capitalists in the form of information asymmetry. (Vinturella & Erickson, 2013). Finnish SMEs tend to lack sufficient management skills, particularly in new technology-based firms where entrepreneurs have more technical than managerial knowledge, and thus often lack the skills to develop a successful commercial business. (Lumme et al, 2013).

The portfolio companies usually have new business models and lack financial and corporate data due to the short operating history. It is also difficult to obtain comparable market data on new, innovative business plans and the degree of comparability is hard to define (Werner et al, 2016). As data and information are the foundation for investment monitoring, the scarcity of data aggravates the information availability for the venture capitalist. Data scarcity could also, in the worst-case, lead to unintended accounting frauds, such as reviewed in the section of window dressing (Cumming & Johan, 2014).

4.2 Risk management

Risk management is according to Vinturella & Erickson (2013) the identification, analysis and treatment of exposures to loss. A risk exists in situations with a multiple number of possible outcomes, from which at least one is classified as a negative outcome. It is said that if there are resources that can be lost, then a potential risk is faced. Risks create both uncertainties and the need for offsetting possible losses, wherein the process of

risk management is a continuous process with ongoing company activities. (Vinturella & Erickson, 2013).

Venture capitalists invest in start-ups and growth companies with a high uncertainty regarding future returns, meanwhile having an underlying information asymmetry toward their contracting party (Räty, 2019). With proper risk management processes and tools, the negative effects of information asymmetry can be reduced. It also reduces the amount of unsuccessful investments, ensures a proper level of risks and is an important factor for limited partners in their decision-making process. (Proksch et al. 2016).

Rätys (2019) findings indicate that venture capitalist companies focus their risk management efforts more on pre-investment processes, such as due diligence, diversification and contracting, than on post-investment processes. In post-investment processes the risk management is mostly related to managing portfolio company specific risks, where they can control risks by offering advice and support. (Räty, 2019).

Theory suggests that, no matter what, agency problems will arise. It has been shown that, without agency issues, the principal would obtain all the risk and the agent would receive a fixed payment. The data of such research indicate that such an arrangement is not preferred by most of the entrepreneurs either, as entrepreneurs prefer to have the same potential for gain as the investors. Scholars have also argued that venture capitalists possess the ability to mitigate information problems, such as moral hazard, but that there are no means by which information problems are entirely eliminated. (Cumming & Johan, 2014).

As the agency risks are presumed to be inevitable and impossible to overcome, the venture capitalist needs risk mitigation mechanisms that enable managing the consequences that arise from information asymmetry. There is a need for different mitigation mechanisms as the risk levels fluctuate depending on the stage of the venture investment (Caselli, 2018). The root causes of the consequences associated with information

asymmetry also varies, due to which different mechanisms are needed depending on whether they are a direct consequence of the agent's actions or solely due to the nature of the company. Mitigation mechanisms can be enforced by either law or through contractual clauses (Armour et al, 2009) and will be reviewed in the next chapter.

5 Legal Strategies to Mitigate Information Asymmetry

Venture capital investing is about making investment decisions under prevailing information asymmetry (Tykvová, 2007) and regardless of the uncertain future. The earlier the investment stage is, the greater is the expected uncertainty of the outcome. (Huang et al, 2015). Agency conflicts play a vital role in shaping the relationship between the venture capitalists and entrepreneurs that operate under these uncertain circumstances (Armour et al, 2009).

The problems are more severe for younger firms, such as start-ups, which is why some venture capitalists prefer to focus on growth firms that are more established. (Amit et al, 1998). For a venture capitalist to manage the uncertainties, different mechanisms are needed (Huang et al, 2015). Previous research on venture capital investing have suggested a variety of control mechanisms to minimize agency costs and implications that are associated with moral hazard.

Legal structures distribute power and payoffs within companies in order to reduce opportunism (Armour et al, 2009). Cumming (2006) has shown in his research, that corporate legality is a central mechanism by which agency problems can be mitigated between shareholders and entrepreneurs. The degree of moral hazard varies between nations, as it is depending on the extent to which national laws protect and enforce areas such as shareholder rights. (Cumming, 2006). Bellavitis et al, (2019) also show that the use of control rights seems to be more valuable within institutions where shareholder protection is stronger. (Bellavitis et al, 2019).

Corporate law has according to Armour et al (2009) two main functions: to establish structures of corporate forms with supporting rules and to control agency problems among corporate actors. Law has therefore the important role of being able to reduce agency costs by the implementation of rules and procedures, where it seeks to find optimal solutions that maximizes the accumulated welfare of both agents and principals. (Armour et al, 2009).

As venture capitalists operate under contractual freedom, not all mitigation actions can be directly regulated by legislative rules and standards but also need enforcement from contract law. Binding contracts are important, where for example covenants are a key instrument in contracting, that regulate the contracting relationship by settling and defining regulating rules (Caselli, 2018). Different covenants will be reviewed throughout this chapter and, as will be seen, venture capital contracts typically contain several sets of covenants (Antonczyk et al, 2011). Covenants can prove effective in mitigating the imbalances of information in contractual relationships and they can be either positive, listing what the company needs to do, or negative, included in order to forbid a set of actions (Caselli, 2018).

Following the reasoning of Armour et al (2009), the legal strategies for reducing agency issues can be divided into the categories of normative regulatory strategies and descriptive governance strategies. Regulatory strategies dictate substantive norms that monitor the contents of principal-agent relationships whereas governance strategies attempt to facilitate control for the principal over their agent's behaviour. Figure 6 illustrates several mechanisms on legal methods of handling agency problems. Ex-ante strategies refer to strategies that take full effect prior to an agent's actions and ex-post strategies refer to the quality of the agent's actions in hindsight. (Armour et al, 2009).

	Rgulatory strategies		**Governance Strategies**		
	Agent Constraints	Affiliation Terms	Appointment Rights	Decision Rights	Agent Incentives
EX ANTE	RULES	ENTRY	SELECTION	INITIATION	TRUSTEESHIP
EX POST	STANDARDS	EXIT	REMOVAL	VETO	REWARD

Figure 6: Strategies for Protecting Principals (Armour et al, 2009)

The two main factors that govern contracting are economics and control. Economics refer to the return that the investor receives at liquidation, whereas control refers to mechanisms by which the investor can exercise control over the portfolio company.

(Ramsinghani, 2014). The contract between the entrepreneur and the investor is built on an interconnection. The entrepreneur offers the investor benefits of ownership and knowledge-sharing and the investor offers the opportunity to spread the risks and to acquire financing. (Reid, 1998). An agency-principal relationship in its simplest form would mean that the venture capitalist, as a principal, controls contractual details and assign tasks to the entrepreneur who bluntly accepts this authority and performs on behalf of the investor. In reality, the principal can only gauge the effectiveness of the agent's actions indirectly, where payoffs and outcomes are the most obvious examples. (Reid, 1998).

This chapter investigates potential mitigation actions that can be utilized to reduce moral hazard implications. The explored mechanisms are both set at a governmental level as well as on individual level. The governmental strategies will be covered from a substantive law point of view as well as by control mechanisms that can be exercised by individual venture capitalists, primarily related to contractual and control strategies.

The framework by Armour et al (2009) will be used to explore legal mitigation actions of information asymmetrical risks that were identified in the previous chapter, with the enhancement from other research as well as the Finnish legal system. As venture capitalists cannot eliminate the information asymmetry of moral hazard completely (Amit et al, 1998), potential disadvantages with the mechanisms will also be weighed in. As this dissertation only deal with agency relationships prevailing after an investment has been established, all mechanisms will be adapted to and presented from that viewpoint. It should also be noted that there is no unanimous way to categorize the mitigation actions in the chosen framework (Armour et al, 2009), hence several mechanisms touch on the same areas.

5.1 Agent constraints

Legislators can directly impact the agency relationship by implementing rules and standards that constraints the agent from making decisions or from undertaking actions that

would be misaligned with the interests of the principal and potentially harmful for the investment. Rules are implemented to both require and prohibit the agent from specific behaviour and are commonly used to protect investors. Standards are specially designed for dealing with intra-corporate relations that leave the precise determination of compliance to adjudicators after actions have already been undertaken and are also implemented for investor protection. (Armour et al, 2009).

The protection of investor rights is grounded in the widely accepted perception of the investor's weaker market position. Investor protection in Finland is mainly achieved by regulating the obligation to provide information, which contains clauses prohibiting the presenting of false or misleading information (AML 1:3). The securities market law also sets requirements on providing investors with information continuously and regularly (AML).

As the securities market law is applied on listed companies operating on the securities market, such information clauses must be contracted for the investor's protection if desired in a venture capital scenery, as the venture funds are directed toward unlisted companies. However, when reaching the exit stage and IPOs, the securities market law obliges the company to file a prospectus for the offering of stocks according to AML 3:3. The prospectus helps investors to make informed investment decisions as it contains relevant information about the investment security, such as the company's key financials (2019/980/EU).

Unlisted companies are still held responsible for following good accounting practices accordingly with the Finnish accounting law (KPL 1:3). The accounting principles set out in the law obliges the accountable party to give a fair and correct view of the financial situation, thus preventing the entrepreneur, in this case, from misleading or hiding information from stakeholders. Accounting can thus have a positive effect on the informational imbalances as it reduces information asymmetry, such as window dressing, and improves monitoring.

On the other hand, if the reporting systems in the portfolio companies are underdeveloped, accounting could also provide the entrepreneur with a possibility to produce figures with a certain financial outcome in mind and, thus, still mislead the investor. (Shakespeare, 2020).

5.2 Affiliation terms

Lawmakers can dictate terms of entry as well as exit opportunities to the principals that allow them to detach themselves from opportunistic agents (Armour et al, 2009). Since the entry terms are primarily linked to the pre-investment stage, this section will only cover exit strategies. However, it should be noted that negotiating investment terms and closing the deal is a critical stage done prior to the investment decision (Räty, 2016), that also impacts the relationship post-investment. This stage lays the foundation for the relationship between the parties as well as the understanding of it, often in the term sheet. The principal seeks to sign a contract that will obtain an optimal level of effort and risk sharing, in order to separate the agent from minimizing efforts. (Reid, 1998).

The exit strategies provide the venture capitalists with termination options, while enabling monitoring over the portfolio company and thereby a better overlook of potential moral hazard implications. Term sheets, that often are amongst the first documents to be signed between the parties, is also laying out how to solve potential conflicts of interest during the investment stages. (Vinturella & Erickson, 2013).

Due to the uncertain conditions under which venture capitalists are usually made, the venture capitalist often phases the commitment of capital, maintaining the option to withdraw from a project (Wang & Zhou, 2004) and exit the investment (Armour et al, 2009). This is done by *staged financing*, which is a control mechanism where the capital investments are paid in separate, smaller instalments instead of all at once (Vinturella & Erickson, 2013). The financing is in correspondence to company development progress and should be supporting the company into entering the next development phase

(Tykvová, 2007) as well as minimizing the financial risks for venture capitalists (Cumming & Johan, 2014).

Staged financing is implemented as covenants in order to control investment risks and to incentivise the entrepreneur (Tennert et al, 2018). By staging the investments, venture capitalists are able to reduce some of the associated investment risks (Vinturella & Erickson, 2013) by learning about the company and its potential over time (Lerner & Nanda, 2020). There can be several funding rounds and usually the invested amount grows by time. By scaling the investments, the investor is empowered to gather information and monitor the progress of projects, while retaining the option to quit (Vinturella & Erickson, 2013) and not lose money on unprofitable projects (Wang & Zhou, 2004). Staging the capital funds is especially important in the earliest stages of the investment, when the investment risk is the highest (De Clerq & Manigart, 2007).

As long as the company demonstrates success with the business plan, venture capitalists stage the future investments to take place every year or two to support further growth (Vinturella & Erickson, 2013). Between each round of financing, the investor can evaluate the viability of the company and, at the same time, encourage the management of the company to act sensibly. (Wang & Zhou, 2004). The evaluation of viability can for example be a screening process of whether certain milestones are being met (Cumming & Johan, 2014).

As the agent's efforts are hard to observe and only noticeable at the end of each financing period, the venture capitalist has to influence the entrepreneur to put in effort already at the beginning of each period. If the entrepreneur is able to achieve the set goals already at the beginning of the period, the business growth is promoted, and agency costs minimized. (Wang & Zhou, 2004).

Even though staged financing is primarily seen to benefit the investor, also the entrepreneur yields gains. Staging the investments allows the company to evaluate its business

and rise with each round, enabling the entrepreneur to decide on the source of funding that fits them best at each development stage. (Vinturella & Erickson, 2013). By staging the investments, the management of the company can thus also be directed to forecast their business in a realistic way, under the threat that they would not receive further financing if targets are not met (Tykvová, 2007).

Staging the capital investments need control variables, as staging the investments could otherwise lead to the entrepreneur window dressing their financial figures in order to secure the next financing round (Tykvová, 2007). The control variables could be related to the amount invested in each period as well as the duration and number of periods (Wang & Zhou, 2004).

Young companies often lack proper reporting systems and regular methods of financial evaluation unlikely leads to reliable data as most ventures work with new business plans that lacks data to evaluate or conducting forecasts. Setting up financial systems with qualitative and accurate data within the portfolio company is nevertheless often a requirement for venture capitalists, in order to prevent the entrepreneur from portraying the performance better than it is. (Cumming & Johan, 2014). It could also allow the venture capitalist to claim a breach of contract if the entrepreneur would engage in asset stripping and thereby lie about certain aspects of its business, such as asset value. (Werner et al, 2016).

Another affiliation term is the right of transfer, i.e., the right to sell shares in the market, which is a prerequisite in the stock markets and an effective mechanism for correcting management behaviour. By transferring rights, the principal is replaced by a new one that continues the controlling over the firm. The new principal will however offer a price for the shares that impounds the potentially expected future loss of value due to either mismanagement or opportunism. (Armour et al, 2009).

By including a buyback in the exit clauses in the contract, the venture capitalist can use this as an insurance of the shares being bought back in cases where an IPO or sale has not occurred within a certain period (Cumming, 2006). Buyback exits take place when investor stakes are sold to existing company shareholders and are especially effective in cases where the entrepreneur does not want to leave the company. Buybacks can however only occur when the shareholders actually have the money to buy back the shares. (Caselli, 2018). There thus remain a risk here, if the company founders do not have the financial means necessary to buy out the venture capitalist (Isaksson, 2006).

5.3 Appointment rights

The management has a central role in any corporation (Armour et al, 2009) and the trust venture capitalist has in the company management is identified as a cornerstone in a successful investment (Caselli, 2018). The appointment rights of directors or other managers are thus a key feature of controlling a portfolio company in addressing agency problems, due to its nature of allocating control rights between venture capitalists and entrepreneurs. (Armour et al, 2009).

Venture capitalists usually receive extensive control rights that includes board control, in order to influence the decision making and mitigate entrepreneur opportunism. Board positions thus enable, aside from advising, also monitoring (Gompers & Lerner, 2004) and the right to replace the entrepreneur as chief executive officer if the company underperforms (De Clerq & Manigart, 2007). As the interests between venture capitalists and entrepreneurs are not always aligned, the venture capitalist has strong incentives to monitor the entrepreneur’s actions and secure the use of the transferred capital (Caselli, 2018).

As has been mentioned, the venture capitalist presumably values a rapid exit higher than the entrepreneur, who has longer term focus to secure firm survival and generating personal income (De Clerq & Manigart, 2007). The venture capitalist wants to avoid investing in a low-value firm with a weak outlook, that the entrepreneur is either aware of, but

not communicating, or unaware of. The unawareness is a frequent issue due to the company valuation, which are estimated based on future values and not current values (Vinturella & Erickson, 2013).

Corporate governance rules set out disciplines for the structure and operation of main company functions (Caselli, 2018). In a limited liability company, the managing director oversees the business administration as well as ensures the lawfulness of the company's accounting and treasury (OYL 6:17). The board, on the other hand, is a strategical body responsible for the overall government and for guaranteeing proper business activities (OYL 6:2). The investor usually participates in the invested business by sitting on the board of directors, by which the operations of the firm can be controlled, and the investment protected (Cumming & Johan, 2014).

Incorrect management decisions from the management team could have a negative impact on the firm's performance and the company value (Caselli, 2018). Obtaining a board seat could reduce moral hazard implications by the venture capitalist being able to steer the business toward a desired direction and have a comprehensive access to a portfolio company's information (Räty, 2016) and thus directly monitor the company (Bellavitis et al, 2019). In a study conducted by Räty (2016) board seats and influencing the selection of the executive management team showed to be such a prominent feature that it was even non-negotiable to many investors. (Räty, 2016).

While board control mitigates information asymmetry to a certain extent, it does not eliminate it completely. Board control does not guarantee a sufficient control over the invested company. Even though board representation guarantees a certain degree of influence over the portfolio company, board members must still act accordingly with the interests of all shareholders. The monitoring may also lead to a trade-off between the benefits of venture capitalist support and interference due to the costs that arise. (Bengtsson, 2009).

Within companies, important discussions are often held outside of board meetings and the information does not flow freely (Fried & Ganor, 2006). A venture capitalist may thus remain uniformed about important items. This implication could be further enhanced if the parties have a geographical distance between them, making monitoring of the entrepreneur's actions harder (Huang et al, 2015) and likely decreases the number of meetings held between the parties (Caselli, 2018). Researchers have thus recognized venture capitalists to value proximity when investing (Huang et al, 2015).

5.4 Decision rights

Supporting the decision making is what enables value creation in a venture capital investment (Caselli, 2018). Decision rights give principals the power to intervene in a firm's management, by either initiating or ratifying management decisions (Armour et al, 2009). Bellavitis et al (2019) show that venture capitalists negotiate board seats and veto rights in accordance with the perceived degree of moral hazard risk. Decision rights are control rights, by which the venture capitalist can control desired outcomes while blocking undesired outcomes. (Bellavitis et al, 2019).

Restrictive covenants can be included in the investment's legal documents that allocate control rights to investors (Bengtsson, 2009). Board control is thus often combined with the venture capitalist receiving protective provisions, that can for example require venture capitalist approval for certain transactions, like the sale of assets. A further possible step is for the venture capitalist to negotiate for a catch-all provision, that would require venture capitalist approval for most major transactions. (Fried & Ganor, 2006). Simultaneously, these clauses could also provide the venture capitalist with covenanted veto rights, enabling the venture capitalist to deny important business decisions and to impose constraints on the entrepreneur's decision making (Bengtsson, 2009).

The venture capital contract can also include a clause that prevents the entrepreneur from selling their quotas against the will of the venture capitalist. Such covenants would thus require venture capitalist approval before an entrepreneur sells their shares to a

third party. Pre-emption clauses are an important clause to include, as they empower existing partners the right to buy shares from the other existing party and prohibits a party from exiting the investment by the selling of shares. Another related clause is a permitted transfer clause, that ensures stability between the parties' commitments. (Caselli, 2018).

Covenants are however costly as they are related to bargaining and enforcement efforts. Bengtsson (2009) therefore imply that these should only be used if "control right allocations lead to a net reduction in conflicts of interest and thus increases the overall company value". (Bengtsson, 2009).

5.5 Agent incentives

The third governance strategy, and fifth legal strategy, is agent incentives. The principal can by reward strategies recognize the agent for successful advancement of the principal's interests (Armour et al, 2009) in the form of incentives, that reduces moral hazard by steering the entrepreneur to put in effort and to work toward common goals (Wang et al, 2016).

Incentives can be executed through sharing rules, that motivates loyalty by tying the agent's monetary returns directly to the principals. Another option is to use a pay-for-performance system, where the agent is still paid for advancing the principals interests but not sharing the principals returns. (Armour et al, 2009). Establishing performance-linked pays is also a way to incentivise the portfolio company's management (Reid, 1998).

Steering the entrepreneur toward desired actions can be done through rewards. The impact of information asymmetry can be reduced through rewarding the agent when their acts are in accordance with the objectives set by the principal (Jensen, 1983). The lack of complete observability of actions could possibly mean that the entrepreneur is required to agree to a contract with an incentive for effort and in which at least some risk is born by the entrepreneur. (Reid, 1998).

Armour et al (2009) state that the trusteeship strategy removes conflicts of interest ex-ante. Past research believe that reputation is a crucial component of the incentive mechanism (Wang et al, 2016). The trusteeship strategy state that agents will respond to incentives such as conscience, pride and reputation to manage the principal's interests in the absence of monetary incentives. (Armour et al, 2009). For example, if the entrepreneur has a fairness preference, it has been shown that the incentive degree to them from the venture capitalist will increase (Wang et al, 2016).

The earlier covered control mechanism of staged financing could also be seen as an incentivizing mechanism, where the venture capitalist is able to steer the entrepreneur to work toward the desired, common goals (Tykvová, 2000). Cumming & Johan (2008) have also raised interest alignment as a way to manage information asymmetry and agency conflicts (Cumming & Johan, 2008). Achieving certain milestones secures them the next financing round. By staging the financing, the entrepreneur is kept motivated to put in effort and work toward success. (Tykvová, 2000).

Incentives as a reward structure require monitoring and agency costs are thus not removed. It is hard for the venture capitalist to identify the extent to which an outcome is due to the entrepreneur's agent and actions and not simply due to good fortune. Also, the asymmetric information is not completely removed since the agent is still in possession of superior knowledge regarding business operations. (Reid, 1998).

Preferred equity also represents one method by which monitoring difficulties can be dealt with from an incentive-compatible manner (Trester, 1998). Preferred shares are the most adapted form of securities in some countries, as they possess advantages over common shares such as special voting rights, being convertible and have dividend and liquidation preferences. As common shares do not offer the investor any special rights, they are rarely chosen as securities especially at early development stages. (Vinturella & Erickson, 2013). The venture capital investment also often contains clauses that allow

the venture capitalists the *conversion of shares*, that also are a way to reduce information asymmetry and entrepreneur opportunism. (Trester, 1998).

The distinction between preferred and common shares is not as prominent in the Finnish legal system as it is for example in the U.S., OYL 3:1 however covers the conversion of shares. Clauses on share conversion are usually included in the shareholder's agreement that outlines the ownership, where the investor wants to secure that the cooperation with the company will run smoothly by keeping the management committed to the company through taking them into account in the distribution of shares. (FVCA).

Many venture capitalists also include contractual clauses that where the entrepreneur's stock options do not become effective until a few years after the initial contract or upon the company achieving certain milestones (Cumming & Johan, 2014). By vesting the entrepreneur's equity over a time period, the losses generated by a hold-up situation could be minimized as vesting provisions puts the entrepreneur at loss of the right to obtain additional funding, in case they quit their job contradictory with the venture capitalists interests (Antonczyk et al, 2011).

5.6 Other contractual strategies

Previous research declares contracting as an effective mechanism both in reducing agency costs and in controlling other risks. (Wang & Zhou, 2004; Gompers, 1995). Nearly any contractual relationship in which one party is under performance obligation to another party is a potential subject to agency problems (Armour et al, 2009). The problem lies in motivating the agent to act in the principal's interests rather than simply their own (Armour et al, 2009).

The legal strategies that have been covered are dependent on the existence of other legal institutions, such as courts, to secure that the legal norms are enforced and that principals intervene to generate interest conformity (Armour et al, 2009). To a high extent, the mitigation strategies that have been covered so far are also contractual

strategies (Armour et al, 2009). For example, the agent constraints, as reviewed in the first section of the chapter, can also be included in legal documents between the entrepreneur and venture capitalist. By contracting the behaviours of the entrepreneur as well as stating the rules about financial expenditures, the investor stays in control of their invested funds and moral hazard is mitigated. (Waarsenburg, 2017). There are also other contractual strategies in mitigating information asymmetry that will be covered next.

5.6.1 Syndication agreement

A frequently used investment strategy, where multiple venture capitalists coordinates an investment, is called a syndication (Lerner, 1994). The basic idea is that each investor within the syndicate puts in a capital fund in the proportion of the amount that is needed to fund the business, in order to share risks and resources (Cumming & Johan, 2014). Syndicating investments are common especially in early stage companies within the venture capital sector (Cumming & Johan, 2014) as it provides investors with collaboration, sharing of information (Lerner, 1994) and increases investment power (Caselli, 2018). Syndications are a method to reduce problems that are generated from informational asymmetries, due to which it also is argued to lead to better business performance and an ability to pick out high-quality projects (Lerner, 1994).

Syndicate agreements govern the relationship between the investors, where it for example outlines monitoring strategies of the syndicate. The co-investors are chosen by the portfolio firm and the lead venture capitalist. In conditions of high uncertainty, it is profitable to have mutual trust and understanding and thus partner with a similar investor. At mature stages diversity is given a different value. (Huang et al, 2015).

As earlier mentioned, there can be proximity preferences in the screening of potential investment opportunities. Syndication could be a solution to such geographical issues, as a foreign firm could invest with local investors that would assist them in the monitoring of the firm and thus reduce information asymmetry. (Huang et al, 2015).

Previous research state that with syndication, better decision making is related to evaluating a firm's potential (Cumming & Johan, 2014). Under conditions of high uncertainty, it could be profitable to have mutual trust and understanding by partnering with an investor (Huang et al, 2015). Syndication agreements are also utilized closer to the exit stage. As the venture approaches a potential IPO, many venture capitalists prefer to form a syndicate to handle selling of the issue (Vinturella & Erickson, 2013).

Casamatta and Haritchabalet (2007) have also found evidence on syndications being costly on post-investment performance, due to less effort being put in (Casamatta & Haritchabalet, 2007). Such costs can also arise from difficulties coordinating between principals, that would lead principals to delegate more of their decision making to agents. Multiple principals can also lead to difficulties in monitoring the agent or in deciding when and whether to intervene with actions (Armour et al, 2009). To reduce such coordination costs, Bellavitis et al (2019) propose that familiarity, i.e. co-investing with the same syndicate partners over time, could reduce possible conflicts (Bellavitis et al, 2019).

5.6.2 Active involvement

As the consequences stemming from moral hazard-situations can be highly harmful to a venture capitalists portfolio company, it is necessary for the venture capitalists to supervise and monitor the entrepreneur's activities continuously. The active involvement of the venture capitalist in the invested firm is a way of reducing the moral hazard implications (Amit et al, 1998).

Venture capitalists vary in their interactions with the entrepreneurs and the post-investment relations between venture capitalists and entrepreneurs can be close and constructive, in the context that the venture capitalist provides advise, utilizes business contacts and facilitate the financing. The relationship also consists of monitoring the performance in a variety of ways. (Reid, 1998). Monitoring rights such as voting rights, board seat rights and liquidation rights are all formalities which are contracted and have been

covered. However, there are also other, less formal, active monitoring strategies a venture capitalist can undertake.

As venture capitalists are to a great extent dependent on those at the core of the business providing them with information, the monitoring is usually performed by superintending, influencing and interfering in the portfolio company whenever necessary (Werner et al, 2016). Without monitoring, the entrepreneur is assumed to be indifferent between effort and no effort. However, if monitoring occurs, Reid (1998) shows that the entrepreneur will prefer to exercise effort instead of refraining from doing so. Shareholders' agreements can set an informational obligation to the portfolio company, whereby the management is committed to provide its investors with information. In practice, this can mean e.g. monthly or quarterly reporting. (Reid, 1998).

It is important for a venture capitalist to select the right managers and to track changes in the quality of the personnel as well as other changes that can impact the quality of management. In addition to board meetings, venture capitalists can hold frequent meetings and reviews with the portfolio company where the entrepreneur is expected to provide them with information (Caselli, 2018). This is, as earlier mentioned, a method to obtain investor rights equal to those of listed companies set out in the securities market law. The frequency of the meetings could be dependent on the company performance but should be held monthly or at least quarterly. Information is expected to be provided regarding items such as potential risks that could be harmful to the investment performance as well as financial and operational data. (Caselli, 2018).

Such special information rights are a widely established contracting element (Antonczyk et al, 2011). As Välimäki (2014) notes, information covenants are widely used in financial agreements and are a means by which the entrepreneur, in the context of this study, is obliged to provide venture capitalists with information (Välimäki, 2014). Information covenants support a continuous communication between the parties, allowing the venture capitalist to verify the competence of the management (Caselli, 2018).

Previous research has found that partners within a venture firm who have prior business experience are more prone to be active in the portfolio companies and that activity generates better business performance (Bottazzi, 2009). On the other hand, a high activity level in the portfolio company could also have a negative effect, where venture capitalists act as “fire-fighters” and only react when they are needed (Isaksson, 2006).

6 Conclusions

In this chapter the thesis will be concluded by summarizing the study and discussing the most relevant research findings as well as contributions. Thereby a further consideration is given to the research limitations as well as to suggestions for further research.

6.1 Research findings

This paper has reviewed literature and studies which present the current state of research in the rapidly developing field of entrepreneurial finance. Venture capital investments have become an established funding source that provide start-ups with both capital funding and know-how. The investments are said to support innovation, as start-ups and early stage growth companies are vital for economic growth, but often lack the resources necessary to materialize their business plans (Vinturella & Erickson, 2013). Venture capital markets are characterized by multiple asymmetrical information problems in an uncertain environment, out of which most related actions are typically non verifiable, making it difficult to cover ex-post actions to a complete extent (Tykvová, 2007).

Venture capitalists and entrepreneurs enter contracts that influence their behavior and mitigates agency costs arising from information asymmetry, by selecting an appropriate kind of financing and by specifying rights and obligations for both contracting parties. Amit et al (1998) state that venture capitalists are investors that become skilled at selecting good projects in environments with hidden information and that they are good at monitoring as well as advising entrepreneurs who might be in the risk zone of moral hazard implications. (Amit et al, 1998).

The overall purpose of the thesis was to increase the understanding of legal mitigation actions that the venture capitalist has at hand to reduce the implications arising from information asymmetry in a post-investment setting.

The research question was formed as:

> *How venture capitalists can, through legal strategies, mitigate post-investment risks related to information asymmetry arising from the relationship with the entrepreneur*

By considering the research question and the theoretical framework of information asymmetry, especially that of moral hazard, a schematic structure of post-investment risks was established. Changes in the entrepreneur's behavior, misaligned interests between the contracting parties and unequal distribution of information were identified as risks that are directly related to the actions of the entrepreneur. Information asymmetrical risks indifferent to the actions of the agents was identified as corporate risks associated with the start-up nature of the portfolio firms.

In order to tackle the post-investment risks, another schematic structure was used to explore the legal mitigation actions within risk management. This thesis utilized the categorization established by Armour et al (2009), who divides the mechanisms into regulatory strategies and governance strategies. Existing research and the Finnish legal system were screened in order to examine the different methods, whereas the following mitigation strategies could be recognized for the identified post-investment risks:

POST-INVESTMENT RISKS	AGENT CONSTRAINTS	AFFILIATION TERMS	APPOINTMENT RIGHTS	DECISION RIGHTS	AGENT INCENTIVES	OTHER CONTRACTUAL STRATEGIES
Change in behaviour	X	X		X	X	X
Misaligned interests	X	X	X	X	X	X
Unequal distribution of informati	X	X	X			X
Corporate risks	X	X	X	X		X

Figure 7: Legal mechanisms targeting post-investment risks

Thereby, an answer is given to the research question. The venture capitalist can through agent constraints, affiliation terms, appointment rights, decision rights and agent incentives mitigate post-investment risks. These are strategies dependent on the existence of courts, or other legal institutions, in order to secure the enforcement of legal norms

(Armour et al, 2009). More independently of legal institutions, but still within the frame of contract law, other contractual strategies of syndication agreements and active involvement were identified as additional mitigation mechanisms.

Agent constraints and affiliation terms are based on the findings in this thesis most efficient in the sense that they strongly target all the identified post-investment risks. Matters such as monitoring difficulties and costly control mechanisms are nevertheless still prevailing. Appointment rights and decision rights both target many of the identified post-investment risks but fail in this context to target all risks as strongly as the first two. Agent incentives are mostly focusing on entrepreneurial behavior and, thus, mainly able to target the risks of changes in behavior as well as misaligned interests. Other contractual strategies are also a mechanism that has been identified to target all risks, which is natural considering the grouping of legal mechanisms included in the concept.

The analysis of extant research however shows that, while the implications of information asymmetry in venture capital investments are well understood, there are still no mechanism that can reduce the implications to a complete extent. This is a conclusion aligned with what Amit et al (1998) and Cumming & Johan (2014) have previously noted. The main management recommendation derived from the analysis in this paper is that a combination of different mitigation actions is the most efficient strategy to target post-investment risks. A combination would secure that all post-investment risks are targeted and would, at the same time, reduce the net value of the negative consequences that the shortfalls associated with each mechanism potentially causes.

6.2 Contributions

Previous research has to a great extent focused on information asymmetry occurring prior to an investment decision, whereas this dissertation has explored the less researched topic of post-investment information asymmetry. The research thus contributes to the academical field of financial law by applying a new angle to the legal mitigation strategies for post-investment risks that can be fulfilled under the Finnish legal

system. This study could also confirm what previous scholars have already stated, that there are no bulletproof mechanisms to target information asymmetry.

6.3 Limitations

As the nature of the study is explorative, it is important to highlight the limitations what comes to directing the research area to the Finnish market. The primary limitations have occurred in screening the Finnish legal system for rules, norms and court cases. The existing regulations and research related to the Finnish legal system are limited, as the research field is dominated by studies from the U.S. The probable reasons are two-folded, as it could both be due to venture capital being a relatively new area in Finland, as well as the contractual freedom of the parties when entering an agreement.

As venture capital is still a relatively young field of research in Finland, more attention should be given to research topic in a national context. The contributions remain limited in parallel to the limitations with prior research in Finland.

6.4 Suggestions for further research

For further research, it would be valuable to conduct a qualitative study that explores the deployment of legal mitigation strategies within individual companies. It would be of interest to investigate how the mechanisms are used. It would also be interesting to see which are considered to be the most important ones as well as what factors impact the selection of a risk mitigation strategy.

A qualitative research could further be related to a firm's size. This study has brought forward conclusions that would generally suit venture capital firms independent of the firm size. However, a company's risk management presumably differs between small and medium-sized enterprises in relation to large enterprises. In a more extensive study, different firm sizes could be compared to each other.

This thesis is limited to exploring the relationship between the venture capitalists and the entrepreneurs but, as has been noted, the main actors in an investment also include investors. It could thus be of academical interest to investigate the relationship a fund investor has with the venture capitalist. Another related possibility for future research could be to explore the information asymmetry between the venture capitalist and the entrepreneur also from the entrepreneur’s perspective. This would be an interesting angle, as it puts forth other information asymmetrical implications such as the challenges an entrepreneur faces in receiving funding or encountering unfavourable contract terms. If a qualitative study would be conducted, a dyadic nature could be chosen for the research in order to enable a discussion between the venture capitalist and the entrepreneur.

References

Amit, R., Brander, J., & Zott, C. (1998). Why do venture capital firms exist? Theory and Canadian evidence. *Journal of business Venturing*, 13(6), 441-466.

Antonczyk, Ron C., Wolfgang Breuer, and Klaus Mark. "1 6 Covenants in venture capital contracts: Theory and empirical." Venture Capital in Europe (2011): 233.

Armour, J., Hansmann, H., & Kraakman, R. (2009). Agency problems, legal strategies, and enforcement. Available: http://www.law.harvard.edu/programs/olin_center/papers/pdf/Kraak-man_644.pdf Retrieved [21-03-2021]

Bellavitis, C., Kamuriwo, D. S., & Hommel, U. (2019). Mitigation of Moral Hazard and Adverse Selection in Venture Capital Financing: The Influence of the Country's I nstitutional Setting. *Journal of Small Business Management*, 57(4), 1328-1349.

Bengtsson, O. (2009). Restrictive covenants in venture capital contracts. Available: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1459012 Retrieved [21-03-2021]

Bigus, J. (2002). Moral hazard by inside investors in the context of venture financing Available: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=302305 Retrieved [22-03-2021]

Bodde, D. L., & John, C. H. S. (2012). Chance and intent: managing the risks of innovation and entrepreneurship. Routledge.

Bottazzi, L. (2009). The role of venture capital in alleviating financial constraints of innovative firms. EIB Papers, 14(2), 30-52.

Bozkaya, A., & Kerr, W. R. (2014). Labor regulations and European venture capital. *Journal of Economics & Management Strategy*, 23(4), 776-810.

Casamatta, C., & Haritchabalet, C. (2007). Experience, screening and syndication in venture capital investments. Journal of Financial Intermediation, 16(3), 368-398.

Caselli, Stefano, and Giulia Negri. Private equity and venture capital in Europe: Markets, techniques, and deals. Academic Press, 2018.

Cumming, D. J. (2006). The determinants of venture capital portfolio size: empirical evidence. The Journal of Business, 79(3), 1083-1126.

Cumming, D., & Johan, S. (2008). Information asymmetries, agency costs and venture capital exit outcomes. Venture capital, 10(3), 197-231.

Cumming, D. J., & Johan, S. A. (2014). Venture capital and private equity contracting: An international perspective.

De Clercq, D., & Manigart, S. (2007). The venture capital post-investment phase: Opening the black box of involvement. Handbook of research on venture capital, 193218.

Dessí, R., & Yin, N. (2012). The impact of venture capital on innovation. Oxford Handbook of Venture Capital.

European Parliament, Council of the European Union. Regulation 2019/980. The format, content, scrutiny and approval of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market. Available:
https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0980
Retrieved [22-04-2021]

Finnish Venture Capital Association (2020). H1/2020 Finnish Private Equity Activity. Available: https://paaomasijoittajat.fi/wp-content/uploads/VC_in_Finland_H1-2020.pdf Retrieved [13-01-2021]

Finnish Venture Capital Association (2018). How to raise venture capital and private equity funding – a guide for entrepreneurs
Available: https://paaomasijoittajat.fi/wp-content/uploads/2018/03/How-to-raise-venture-capital-and-private-equity-funding.pdf Retrieved [22-03-2021]

Finnish Venture Capital Association (2020). What are venture capital and private equity? Available: https://paaomasijoittajat.fi/en/for-entrepreneurs/what-are-venture-capital-and-private-equity/ Retrieved [13-01-2021]

Fried, J.M. & Ganor, M. (2006). Agency Costs of Venture Capitalist Control in Startups. *New York University Law Review*, Vol. 81, 967-1025

Gerken, L. & Whittaker, W. (2014). The little book of venture capital investing: empowering economic growth and investment portfolios. (Vol. 57). John Wiley & Sons.

Glücksman, S., (2020). Entrepreneurial experiences from venture capital funding: exploring two-sided information asymmetry. *An International Journal of Entre preneurial Finance*, Vol. 22., 331-354

Gompers, P. A., & Lerner, J. (2004). The venture capital cycle. MIT press.

Gompers, P., Kovner, A., & Lerner, J. (2009). Specialization and success: Evidence from venture capital. Journal of Economics & Management Strategy, 18(3), 817-844.

Hillier, B. (1997). The economics of asymmetric information. Macmillan International Higher Education.

Huang, X., Kenney, M., & Patton, D. (2015). Responding to uncertainty: syndication partner choice by foreign venture capital firms in China. Venture Capital, 17(3), 215-235.

Isaksson, A. (2006). Studies on the venture capital process (Doctoral dissertation, Handelshögskolan vid Umeå universitet).

Jensen, M. C., & Ruback, R. S. (1983). The market for corporate control: The scientific evidence. Journal of Financial economics, 11(1-4), 5-50.

Kotowitz, Y. (1989). Moral Hazard, Allocation, Information and Markets, 207-213

Lerner, J. (1994). The syndication of venture capital investments. *Financial management*, 16-27.

Lerner, J., & Nanda, R. (2020). Venture Capital's Role in Financing Innovation: What W Know and How Much We Still Need to Learn. *Journal of Economic Perspectives*, 34(3), 237-61.

Lumme, A., Mason, C., & Suomi, M. (2013). Informal venture capital: Investors, investments and policy issues in Finland. Springer Science & Business Media.

Marcel, B., Oran, T., & Otgon, C. (2010). Information asymmetry theory in corporate governance systems. Annals of the University of Oradea, Economic Science Series, 19(2), 516-522.

Meckling, W.h., Jensen, M.C. (1976). Theory of the firm: Managerial behaviour, Agency

Costs and ownership structure. *Journal of Financial Economics*, 3, 305-360

Mishra, C. S., & Zachary, R. K. (2015). The theory of entrepreneurship. *Entrepreneurship research journal*, 5(4), 251-268.

National Venture Capital Association (2020). Yearbook. Available: https://nvca.org/wp content/uploads/2020/03/NVCA-2020-Yearbook.pdf Retrieved [13-01-2021]

Proksch, D., Stranz, W., Pinkwart, A., & Schefczyk, M. (2016). Risk management in the venture capital industry: Managing risk in portfolio companies. The Journal of Entrepreneurial Finance (JEF), 18(2), 1-33.

Ramsinghani, M. (2014). The business of venture capital: insights from leading practitioners on the art of raising a fund, deal structuring, value creation, and exit strategies. John Wiley & Sons.

Reid, G. (1998). Venture Capital Investment: An Agency Analysis of UK Practice. Routledge.

Räty, K. (2019). Risk Management in Venture Capital Companies (Master's thesis).

Shakespeare, Catherine. "Reporting matters: the real effects of financial reporting on investing and financing decisions." Accounting and Business Research 50.5 (2020): 425-442.

Sun, W., Stewart, J., & Pollard, D. (Eds.). (2011). Corporate governance and the global financial crisis: International perspectives. Cambridge University Press.

Tennert, J., Lambert, M., & Burghof, H. P. (2018). Moral hazard in high-risk environments: optimal follow-on investing in venture capital finance. Venture Capital, 20(4), 323 -338.

Trester, J. J. (1998). Venture capital contracting under asymmetric information. Journal of Banking & Finance, 22(6-8), 675-699.

Tykvová, T. (2007). What do economists tell us about venture capital contracts?. *Journal of Economic Surveys*, 21(1), 65-89.

Vinturella, J. & Erickson, S. (2013). Raising Entrepreneurial Capital, 2nd Edition, 175-180

Välimäki, O. (2014). Kovenantit. Rahoitussopimuksen kovenanttiohjaus: vakuuden arvioinnista kohti sopimusoikeudellisia riskienhallintamekanismeja tarkasteltavana erityisesti informaatio ja kumppanuus. Yliopistollinen väitöskirja, Lakimiesliiton kustannus, Vantaa 2014.

Waarsenburg, J. W. A. (2017). The Role of Information Asymmetry in Financing Early Stage Ventures (Master's thesis, University of Twente).

Wallmeroth, J., Wirtz, P., & Groh, A. P. (2018). Venture capital, angel financing, and crowdfunding of entrepreneurial ventures: A literature review. Foundations and Trends® in Entrepreneurship, 14(1), 1-129.

Wang, K., Ding, C., Chen, J., & Li, A. (2016). Venture investment incentive mechanisms and simulation with venture entrepreneurs having multistage efforts based on fairness preference theory. Discrete Dynamics in Nature and Society, 2016.

Wang, L., & Wang, S. (2009). Is staged financing designed for alleviating risks or agency problems?. Handbook of Business and Finance: Multinational Companies,

Venture Capital and Non-Profit Organizations, M. Bergmann and T. Faust, Eds, 191-216.

Wang, S. & Zhou, H., (2004). Staged financing in venture capital: moral hazard and risks. *Journal of Corporate Finance*, Vol. 10, 131-155

Werner, M., Vianelli, A., & Bodek, M. C. (2016). Monitoring venture capital investments through internal control prediction markets (No. 165).