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**MARY GILLY, CHAIR**
UC Academic Council
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**Re: AFS-Equity in Return for Access to University Facilities and/or Services**

The Guidelines on Accepting and Managing Equity in Return for Access to University Facilities and/or Services were forwarded to all standing committees of the Davis Division of the Academic Senate, including school and college Faculty Executive Committees. Responses were received from the Graduate School of Management Faculty Executive Committee (GSM), Faculty Welfare Committee (FWC), Graduate Council (GC), and the Committee on Planning and Budget (CPB).

The divisional review was performed based on the understanding the University is prohibited from enabling the use of public resources for private benefit without fair consideration in return. Thus the purpose of the pilot program is for the University to explore a fair consideration return mechanism whereby the University takes equity in university affiliated startups in exchange for access to facilities allocated for private use by individual colleges and departments.

While some committees acknowledged that the concept of the initiative could potentially be a great opportunity for all parties involved, there was strong hesitation amongst respondents due to the lack of a clear policy proposal. The hesitation was exacerbated given UC Davis was listed as pilot site. The lack of policy direction from UCOP combined with a lack of a clear plan from those responsible for coordinating the UC Davis pilot project leave the Davis Division with little choice other than to indicate we are unwilling to move forward with the initiative or a pilot implementation until there is a stronger foundation for the University, and in particular UC Davis, to build upon. Given the lack of a clear policy proposal, the majority of the feedback received revolved around questions and concerns regarding the guidelines.

<u>Concerns and Questions</u>

GSM indicated that University funding of startups raises several potential conflicts of interest, particularly since the document makes clear that the objective accepts equity in a company will not to make money, but rather (p.7) "… shall be based upon the educational, research, and public service missions of the University over financial or individual personal gain." While this is a laudable goal, it is important that the document clarifies, or provide specifics as to how the educational, research, and public service missions of a startup will be evaluated. Within this context an immediate question is will the University allocate funding if the startup helped to recruit a top-notch faculty member, create jobs or alleviate poverty in California, but was not financially viable? A related concern was raised that the University's academic independence could be compromised with the acquisition of equity in companies. It is entirely possible that at times, the University's financial interests, linked to such equity, could conflict with its primary mission of academic freedom for faculty and students.

The uncertain valuations associated with startups create several issues that require careful consideration. Detailed commentary was provided by a faculty member in GSM with expertise in venture capital (VC): **"**The document is written with the assumption that equity is the common form of security to be issued as compensation for the companies' use of university facilities and/or services. While this is a reasonable assumption for publicly traded companies, it is not the case for young start-up companies that are yet to receive a VC round of funding. Such companies often issue convertible debt or convertible note to angel and seed investors to avoid setting an equity valuation. It is difficult for the University in such cases to determine a fair value of equity for the companies.

Appendix F, Part 2 (Private Benefit), discusses several methods to come up with equity values. Using the price at which options are issued is reasonable for common stock, since options are convertible to common stock, but it is not appropriate as the price for preferred stock, since (convertible) preferred stock has different and typically higher value per share than common stock. Determining the value of preferred stock using the option exercise price requires more advanced financial modeling that takes into account the liquidation preference, participation rights, etc. features of the particular preferred stock.[1]

Generally, taking common stock or convertible preferred stock in a company at "fair value" that has yet to receive VC funding is fraught with valuation challenges, which then exposes the University to various compliance issues with its obligation as a public entity. *Therefore delegating such decision-making responsibility to various campus Designated Campus managers (DCM's) is not recommended*. (emphasis added)

Section D of IV. Equity Guidelines prohibits University employees from serving on the board of directors in a company in which the University has an equity position through this program. It seems highly likely that some of the best candidates for University incubation programs are founded by University affiliates (employees, professors, students), and the whole point of setting up such incubation programs is to contribute to the overall entrepreneurial ecosystem in the local economic region, with the University serving as one of the hubs. This rule may be motivated by the need for compliance, but this seems to handcuff the program too much and undermine its potential for success. This is a sensitive timing issue.

Perhaps one solution is to allow University affiliates to serve on the board (e.g., as the founder/CEO) for a limited period of time, so that they can keep their University positions ("day job") while the company is still in its infancy, but require that such board members either (1) severe ties with the University ("quit the day job and dedicate themselves full time to the company") once the company is in a more developed stage, or (2) resign from the board and play a limited role as a scientific advisor.

It seems unrealistic and too rigid to require that "No consideration shall be given to Company information uniquely available to the University through its AFS pilot": (P. 14, top paragraph). This rule seems financially reckless for the sake of compliance and if enforced could jeopardize the interests of university stakeholders.

It was surprising to see in Appendix D that dispositions of stock have to follow a predetermined schedule (50% upon expiration of lock-ups, another 25% 6 months later, and the remaining 25% 6 months after that). This appears unreasonably rigid for the sake of compliance, and jeopardizes the interests of University stakeholders too much. One could imagine a scenario where the university will

[1] Reference: Andrew Metrick and Ayako Yasuda, 2010, Venture Capital and the Finance of Innovation, Hoboken, NJ: John Wiley & Sons.

be forced to leave a lot of money on the table and dispose the stock at an inopportune time, or conversely miss an opportunity to sell stock before it precipitously loses its value.

Who is the beneficiary of the stock once it is issued–does it belong to the office that runs the incubation program, the Campus at which such program is located, or the Regents? The document refers to “[Campus’] portion of a cash proceeds” in Section C.3 of VI. Chief Investment Officer’s Management of Equity (p.15), but it is not clear how the various portions are allocated to different UC entities.”

Further commentary was provided by a faculty member in GSM with expertise in entrepreneurship: “Fundamentally, why is the equity exchange for accelerator space and services? Why is it not in lieu of patenting costs or licensing royalties as these are often the more burdensome constraints for new ventures (and clearly shared risk for the UC system)? Space (specifically lab space and equipment) may also be valuable, but also possibly available outside.” A similar comment voiced by a review committee was that this project is in some sense based on a theory about the needs of startups, but is there academic or other evidence that startups require these services?

The GSM faculty continues, “Moreover, business support services, particularly from administrative staff based on UC campuses, rarely has the requisite disciplinary, industry, and entrepreneurial experience to be of significant value to new ventures.

How the equity stake to be is determined (i.e. how is the nascent venture valued)? Is it anchored at the discretion of the administrative units of the technology transfer offices, and how does this office claim the ability or experience in making such determinations?

There is a significant power imbalance between researchers negotiating the license for their intellectual property and university administrators negotiating on behalf of the university. If the same individuals and offices are also negotiating for an equity stake based on space and business services, this creates an equally significant potential for conflict of interest and coercion on the part of administrators and pressure to accept unfair terms on the part of the researchers (who have no recourse without the rights to the intellectual property (IP)).

This concern is not about conflicts of interest (COI) based on personal gain, but rather "bureaucratic” gain in terms of the performance of administrative units judged on the revenue they generate from licensing and equity in conflict with the interests of the researchers as well as the interests of the new venture. I would recommend separating, on the administrative side, the valuations and negotiations of the IP licensing from the evaluations and negotiations of the space and services as well as of the value of the venture.

Related to the previous point, there is a stated preference for fully paid securities when often the seed stage investors take a convertible note that is valued by subsequent professional investors in a later investment round. Why not avoid the conflict by placing a cash value on the space and services but not the venture, and have a professional investor set the valuation in a subsequent round (with a scheduled discount).

Additionally, an arbitrary (and completely reasonable) “expectation of dilution” enables an administrator to bypass any limitations (i.e. >10%) on the equity stake it may claim as fair.

The independent auditing of these arrangements needs to be truly independent, which will be difficult as the Office of Patenting and Licensing typically reports to the Office of the Vice Chancellor

Research, which reports to the Chancellor. Moreover, the revenues generated from licensing become discretionary funding for the Chancellor."

Final commentary from GSM came from a faculty member in with expertise in organizational theory, "The guidelines leave grey areas within which university personnel will be afforded considerable discretion. For this reason, it is suspected that problems of an unpredictable sort are bound to arise. Due to this it is believed that this program carries some risk. ….There was belief that a central element of the guidelines might be problematic. It seems that the requirement to calculate the value of the enterprises in question might be quite difficult, insofar as most will be start-up enterprises, the value of which generally will be highly uncertain. Thus, it seems to me that any attempt to balance the value transferred to the enterprises by the university and the value transferred to the university by the enterprises will be fraught with error. The phrase "acting in their capacity as University employees" in the first sentence of section D is unclear (page 9). Does this phrase refer to the state of mind of university employees when they serve on the board of directors of an enterprise receiving value from the University and surrendering equity to the University? More specifically, does this mean that University employees can serve on an enterprise's board of directors, as long as they do not represent their service as provided on behalf of (or with the approval of) the University? If so, this provision seems to be entirely unenforceable."

General Remarks

- A member of the Law School faculty indicated legal rules implicated by this program are not only complicated, but they are in some cases cumulative. Both aspects of the rules can be a problem. Take the rules concerning private use of facilities financed with tax-exempt bonds. Will the campus representative estimating private use be a bond lawyer or consulting a bond lawyer? If not, how can we be certain the estimates are sound? If so, then this might be a considerable expense. Also, to the extent that a single bond issue might be used to fund many projects on many campuses, is there a system to track the cumulative use? If so, this also seems like it could be a significant expense – assuming that the program is successful.

- There was concern that other faculty, not part of this program, would be displaced. Therefore, it is important that "access" for all faculty be protected and that the campus is conscious of any adverse effects on other faculty and their research pursuits.

- Receiving equity in a company could be risky- would it be better to just receive payment? How can we truly know which companies have less risk without enormous training and experience? The document states "Note that each participating campus and Laboratory is expected to designate a DCM who has the relevant experience with and knowledge of startup equity transactions, complex financial instruments and University policy so as to be able to develop its own procedures by ways of standard templates …" Is such experience and knowledge available to the campuses?

- The document states "For example, University inventions should be made available for licensing to appropriate companies and should not automatically be made exclusively available to Companies in which the University has taken Equity under this pilot." Are there exceptions to this where exclusive licenses would occur? If so, that would seem problematic.

- This following statement seems vague: "The Campus or Laboratory's subsequent use and distribution of its portion of any cash proceeds shall be handled in accordance with the schedules, formulas, and practices established by the Campus or Laboratory." There is no timeline or clear responsibility.

- Although the document reports that the President will analyze the program after 3 years, there are no guidelines or metrics as to what would be considered success. Again, how will real and potential cost to UC faculty be quantified and guarded against?

Again, once established properly, the proposal could produce positive outcomes. Based on the lengthy list of questions and concerns, it is clear that there is still much work to be done before the Davis Division of the Academic Senate would feel comfortable supporting a pilot program on our campus.

Sincerely,

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