



Guidance

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The monitoring challenge

How to maintain good governance and oversight post-dilution



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Foreword

This Guidance Note is the third in a series of three which aims to bring practical, actionable advice about good practice to follow for Venture Capital Fund Managers in emerging markets and also for their portfolio companies, as well as any other investor in startups, in the area of governance of startup companies.

BII and FMO have been among the 35 leading development finance institutions which promote the [Corporate Governance Development Framework](#). This framework grades corporate governance practices from basic to best practices across different attributes using a [Progression Matrix](#). The IFC has extended the general progression framework to develop [methodology and tools for corporate governance](#), and has applied the progression matrix specifically to [corporates](#) as well as to [family or founder-owned unlisted companies](#) and to [small and medium enterprises](#).

In a similar vein, others have more recently developed applied governance for startup companies. Among a growing list, we would like to acknowledge in particular, the 2019 [Corporate Governance for Early-Stage Innovative Companies](#), the Resource Guide prepared by the Center for Financial Inclusion and FMO, and the 2023 [Startup Governance Playbook](#) published by Deloitte India and the Indian Venture Capital Association.

This Guidance Series seeks to build on and especially apply the insights from these frameworks to the context of fund managers and investors who shape and participate in the governance of their portfolio companies. Implementing governance measures at an early stage is highly likely to improve startup performance and increase investability.

Guidance notes [1](#) and [2](#) are built around hypothetical case studies in which readers are invited to apply the frameworks to situations which are based on real life. However, these case studies are fictitious and are not based on actual BII or FMO investments. The Notes do contain stories based on published information from recent relevant cases.



🏠 Contents of this Guidance Note

What this note is about and how to use it →

Introduction →

Investor influence declines while risks may increase
Typical scenarios faced by investors as a result of dilution
Information is critical to monitor and influence an investment

Investors should adopt proactive strategies to drive influence →

Extrinsic factors will affect the potential level of influence on governance

SHAPE your influence as a VC Fund Manager →

Strategy 1: Seek proportionate Hard Rights
Strategy 2: Accumulate Soft Power
Strategy 3: Engage the Investment Ecosystem
Phase 1 Pre-investment
Phase 2 Post investment pre-dilution
Phase 3 Post-dilution

A portfolio approach to influence →

Approaches for typical scenarios faced by investors →

Case study: GoHardy, India →

Key takeaways →

↓ Pre-deal Assessment Checklist

↓ Strategy 1: Seek Proportionate Hard Rights

↓ Strategy 2: Accumulate Soft Power

↓ Strategy 3: Engage the Investment Ecosystem



Glossary



Learning Objectives





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Glossary

Anti-dilution rights	Clauses in an agreement which allow a shareholder to maintain certain defined rights when new shares are issued.
Business integrity	This approach looks at how businesses are exposed to financial crimes or unethical practices, including via third-party relationships, and also how the corporate governance, risk and management systems, organisational ethics and values of a company can have impact on performance. Key business integrity topics may include corruption and fraud, money laundering and terrorism financing, sanctions breaches, tax evasion, conflict of interest, whistleblowing, data protection, political exposure, etc.
Dilution or diluted	The process whereby the proportion of equity held by an existing shareholder reduces as new equity is raised.
Ecosystem leverage	A class of indirect leverage strategies exercised by investors in the wider ecosystem, which may include a number of ways in which an investor earns respect and influences relevant parties, including media, industry associations and other investors, in a way which will also influence an investee.
ESG-aligned (investor)	Investors who share a similar understanding of and approach to Environmental, Social, and Governance issues.
Hard Rights	A class of direct influence strategies based on legal rights that give access to information and influence upfront and are embedded in a way that ordinarily requires specific voting thresholds to agree to change them.
Investment ecosystem	The wider environment composed of other investors with an interest in companies in the same sector or country, as well as supporting platforms and bodies.
Right of first refusal (ROFRs)	Right of first refusal – a right which gives a party first option over a defined circumstance.
Soft Power	A class of strategies of influence on an investee which do not involve legal or binding rights but rely on building trusted relationships with the founder/s, board members and other shareholders so that they are more likely to provide information and to take advice even when it has no legal force.
Tag-along rights	Contractual obligations which protect the position of a minority investor by enabling it to sell its stake on the same basis as a majority shareholder if it chooses. Drag along rights require a minority investor to follow the majority in selling its stake.



What

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Learning objectives

As a Fund Manager who invests in startup companies, after reading this Guidance Note, you should be able to:

- » Actively forecast and plan for the **scenarios** in which your influence over an investee may be weakened following dilution.
- » Identify and give examples of **strategies** for exercising leverage on portfolio companies when influence is diluted, and differentiate how these apply throughout **the phases** of the investment cycle.
- » Design and adjust a **leverage strategy** for an investee and across an investment portfolio using a risk-based approach.

Who is the note for?

This Guidance Note addresses the **challenges of Venture Capital (VC) Fund Managers who will likely experience a dilution in their shareholding and related rights** and, as a result, may lose access to information and influence. It may also be relevant for Private Equity Fund Managers who invest in startups or similar companies where their shareholding may be diluted.

The Note sets out a set of **proactive approaches** for Fund Managers to continue to ensure appropriate oversight and shape good governance even as their equity stake is diluted.

What this note is about and how to use it



This Guidance Note is the third in a series for VC Fund Managers and other investors that sets out approaches to encourage and promote good governance at startup portfolio companies. For a comprehensive understanding, this Note should be read together with the previous Guidance Notes.

- » [Note 1](#) highlights a list of common early-warning signs that investors can spot in investees and proactively act on.
- » [Note 2](#) focuses on how to develop a phased and proportionate governance framework based on the stage of development of a startup over time.

This third Note addresses the challenge for startup investors of exerting influence to monitor and shape the governance of portfolio companies while their shareholding and related rights are diluted over time.

A recap on the four components of good governance for startups:



Introduction



Early-stage investors may hold significant shareholdings in startups. For a while at least, these stakes give them **substantial leverage**: they may have the right to appoint a director or a board observer, to approve certain material changes, to install measures and protections around compliance and good governance, and to have access to enhanced information. The extent of leverage will depend on their level of investment, negotiating power and market dynamics at the time.

Regardless of the starting position, as the startup raises successive funding rounds, **early-stage investors' shareholding will be diluted**. Dilution reduces their influence on the company and limits their access to information. Under pressure from market circumstances or from later-stage investors, the company may even reach decisions and take actions that are contrary to the values or investment mandates of its earlier-stage investors, but those investors may have little ability to prevent this. Even though they have limited influence over investee decisions, investors may nonetheless face reputational and even legal and regulatory risks arising from their decisions.

VC Fund Managers who invest in startups therefore need to recognise from the pre-investment stage that **their influence over a startup investee will change**. Accordingly, they need to assess early on how to adapt their monitoring approach post-dilution to ensure that the risk profile of an investment remains within their risk appetite. This assessment will help them allocate their resources to maintain their influence even after dilution. While the assessment needs to happen at the level of individual portfolio companies, VC Fund Managers also need to take a portfolio view to prioritise and allocate their time and resources across their portfolio as a whole. The case for investing time and effort as well as money comes from the recognition that better governance is likely both to drive value and to mitigate investment risk.

This Guidance Note describes scenarios for VC Fund Managers investing in startups to consider, and strategies for them to adopt to ensure **adequate monitoring post-dilution**, with the aim of building better governance and, as a result, contributing to better business performance.



Investor influence declines while risks may increase

Investors' influence on the commercial and ESG strategies of startup investees generally reduces over time.

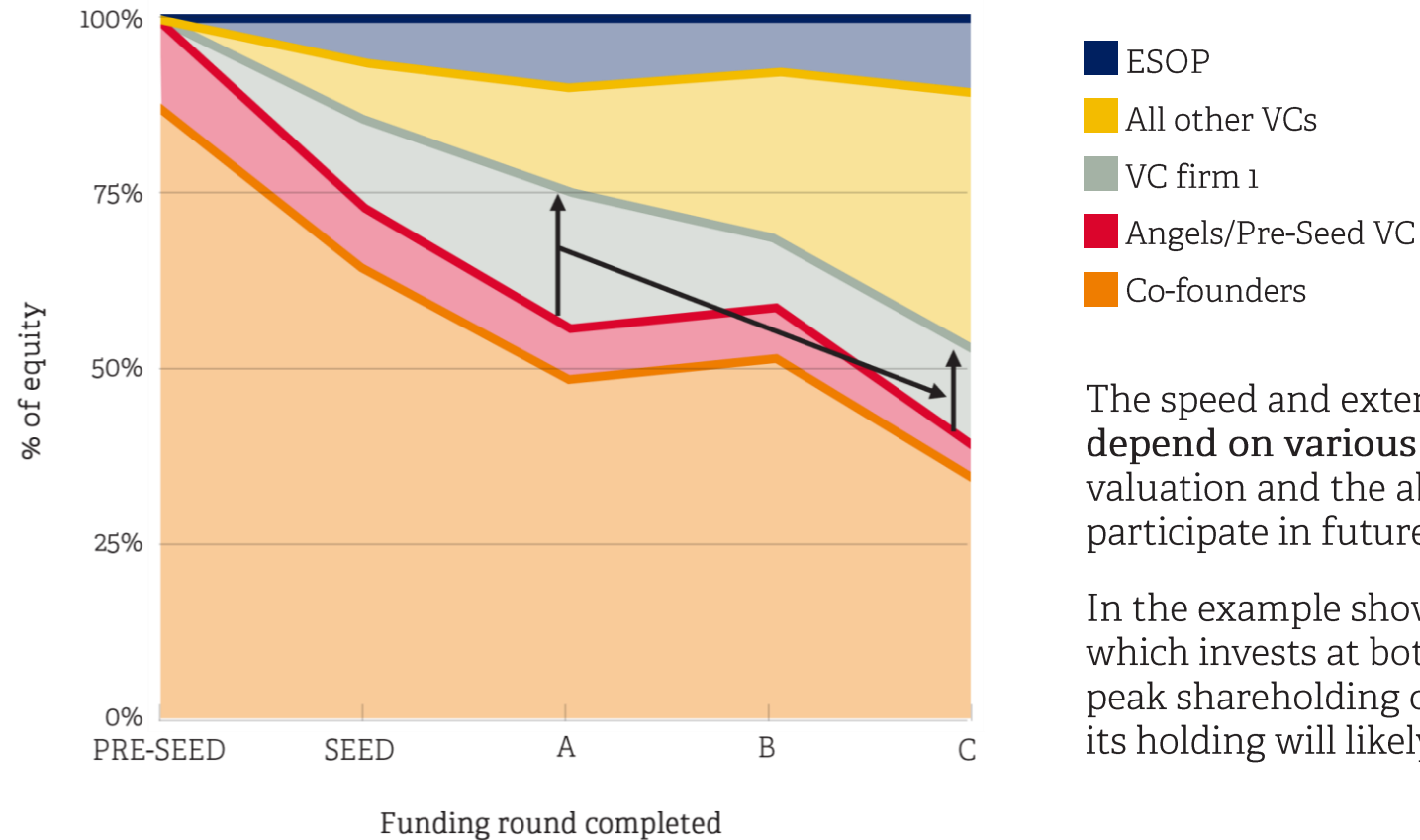
As new investors acquire equity in a company, existing investors' shareholdings are usually diluted unless they also participate in later funding rounds to maintain or even increase their equity holding. Shareholders' agreements commonly define minimum thresholds of shareholding for different degrees of influence. When shareholding falls below a material threshold, for example 10%, shareholders may forfeit certain rights such as the ability to nominate a director, receive additional information through board materials and discussions, influence ESG requirements and/or veto material changes.

At the same time, the risk profile of a startup investee will evolve with greater complexity, scale and market conditions. Investors need at least to be able to monitor changes to inform their own decision-making about the investment.

By anticipating these changing circumstances – diluted influence and potentially higher risk – even from the due diligence phase, VC Fund Managers can adapt their approach and prioritise those actions which will help to promote value in their investments, maintain high ESG standards and good governance, and protect themselves against circumstances which may bring reputational and financial risks.

Figure 1 (Page 9) shows a common path for the evolution of the capitalisation table ('cap table') of a typical startup company over different funding rounds as the relative stakes of different categories – founders, pre-seed investors, VCs and the employee share ownership plan (ESOP) – change.

Figure 1: How shareholdings in a startup may change over time



The speed and extent of dilution of an investor's stake will **depend on various factors**, including the company's valuation and the ability and willingness of the investor to participate in future funding rounds.

In the example shown, a single VC Fund Manager, VC Firm 1, which invests at both seed and Series A rounds, may hold a peak shareholding of 15-20%, but by the time of a C round, its holding will likely decline to below 10%.

Source: Indicative, based on data from Carta.com from 1229 US equity rounds in 2023.

Typical scenarios faced by investors as a result of dilution

Across the phases of the investment life cycle, VC Fund Managers may face scenarios that raise new risks and pose questions about how they can both monitor their investment and exert influence over a startup. Consider the questions raised by these four examples at different phases of the investment life cycle of a startup investee. Later in the Note, after introducing a set of strategies to use, we will return to consider possible ways to answer these questions.



Phase 1

Phase 2

Phase 3

Pre-investment

Scenario 1
Assessing the risks

A startup is seeking to raise Series A funding. It has an attractive digital business model but operates in a country with a challenging business environment and in activities which carry heightened corruption risk due to a high level of interaction with government agencies. None of the current shareholders are ESG-aligned investors.

Recognising that its influence will dilute over time, even if it acquires a substantial stake in the Series A round, how might a VC Fund Manager mitigate possible future ESG risks while ensuring it still participates in this funding round?

Phase 1

Phase 2

Phase 3

Post investment, pre-dilution

Scenario 2 Managing new risks

The VC Fund Manager succeeds in getting a board seat at the same startup after leading the Series A round. Although new investors enter the cap table at Series B, the Fund Manager retains its board seat because it also decided to participate, keeping its stake above the required 10% threshold. However, the company is now struggling to get traction. It proposes to pivot its previously digital-only business model by starting to invest in physical infrastructure and equipment with a substantial footprint.

How can the VC Fund Manager monitor the new risks connected to asset-heavy operations and mitigate the impact of further dilution?

Phase 1

Phase 2

Phase 3

Post dilution

Scenario 3 Adjusting to post dilution

After re-gaining traction, the same startup is able to conclude a successful Series C round in which large new growth investors entered its cap table. The VC Fund Manager that led two earlier rounds has its stake diluted below 10%, losing its board seat. To maintain its growth momentum, the company now proposes to launch new regulated financial products alongside its existing offering.

How can the VC Fund Manager continue to get access to information needed to understand the new risks involved and also to compile the reports that its LPs require?

Phase 1

Phase 2

Phase 3

Post dilution

Scenario 4 Acting on new information

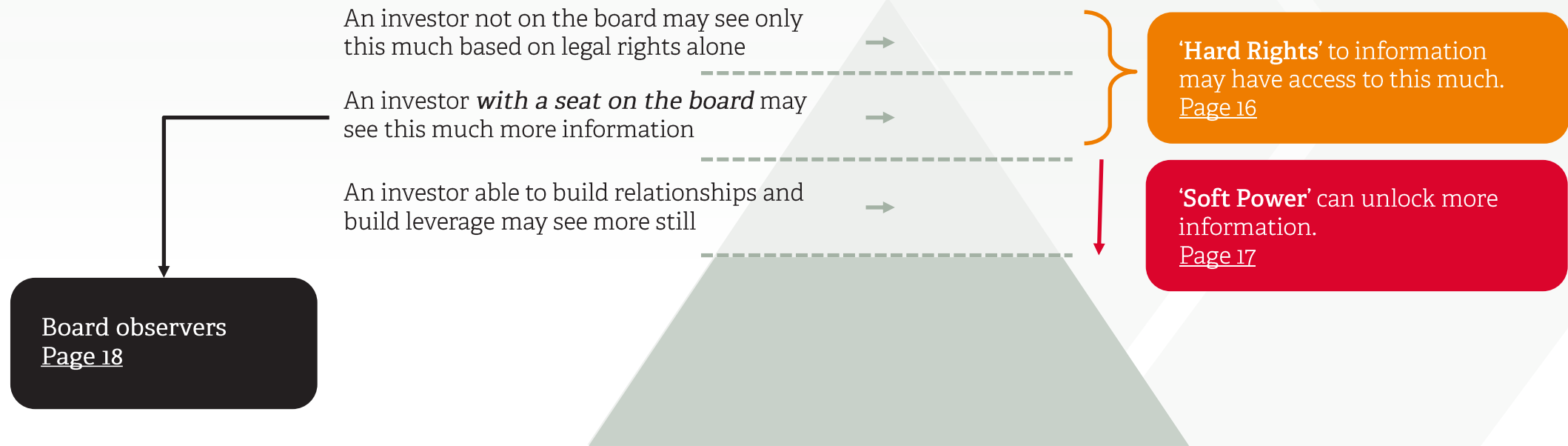
The startup is under pressure from its new investors to build momentum further. It is considering placing substantial orders for equipment from a large new supplier, which is located in a country sanctioned by the international community for its labour market practices but offers attractive pricing.

Now that the VC Fund Manager is no longer on the board and has only a minority stake, what can it do to influence the decision about the supplier?

Information is critical to monitor and influence an investment



There is significant information asymmetry between investors and the founders and leadership teams of companies. Yet without access to sufficient timely and reliable information from portfolio companies, it is difficult for investors to engage and to shape its practices. [Guidance Note 1](#) depicted investors' access to information from an investee company as like layers of an 'iceberg' of information. Much of what is actually happening is below the surface of the 'iceberg' but VC Fund Managers may be able to access deeper layers based on their roles, rights and capacities.



'Hard Rights' to information

Hard Rights can be difficult to negotiate, but by securing and exercising certain **'hard' legal rights and protections** at the time of investment, investors are able to expose more of the iceberg, i.e., they are able to see more, read the signals, and exercise greater control and influence on governance.

These rights include board and observer seats, access to information and audit findings, and appointment and remuneration of executives or board members.

These rights generally give investors a 'seat at the table' with other investors, the board, and senior management, and they also allow them to deepen relationships by virtue of their inherent legal rights and status as 'significant' minority shareholders. However, these Hard Rights need to be exercised with caution based on an assessment of risk.

'Soft Power' can unlock more information

Soft Power strategies include building trusted relationships with founders, the board of directors and co-investors, as well as encouraging the adoption of a relevant and appropriate governance framework for the company's stage and promoting value-adding culture, practices, and policies.

These approaches unlock access to additional layers of information and influence in a startup beyond what Hard Rights can provide.

In addition, those investors that have the time and resources are also able to offer their portfolio companies access to **specialists across multiple functions**, including (internal or external) experts in core areas such as finance, risk, and ESG, but even in areas such as talent, sales, growth, and communication.

All of these resources can provide significant additional value to the company and unlock additional sources of information while building influence of the investor.

Board observers

It is a common industry practice in some countries to provide **board observer rights** to significant investors who fall below the threshold for nominating a director.

Observers do not have voting rights (or fiduciary duties) and may not even be able to speak at a board meeting unless called upon by the chair, but they can follow the board deliberations. The added access to information and people can make observer seats attractive to ensure monitoring.

However, since observers have no decision-making rights, they lack the power to influence decisions directly. Fund Managers should consider carefully the limitations of taking observer rights. If they accept observer status, they should plan ahead the Soft Power strategies which may help compensate for the lack of direct influence.

Investors should adopt proactive strategies to drive influence



While their equity stakes will likely dilute, investors' influence over the commercial and ESG direction of a startup need not inevitably decline, provided they are **proactive and intentional** over the lifetime of the investment. Being proactive starts at the pre-investment phase, when they assess, negotiate, and structure the deal.

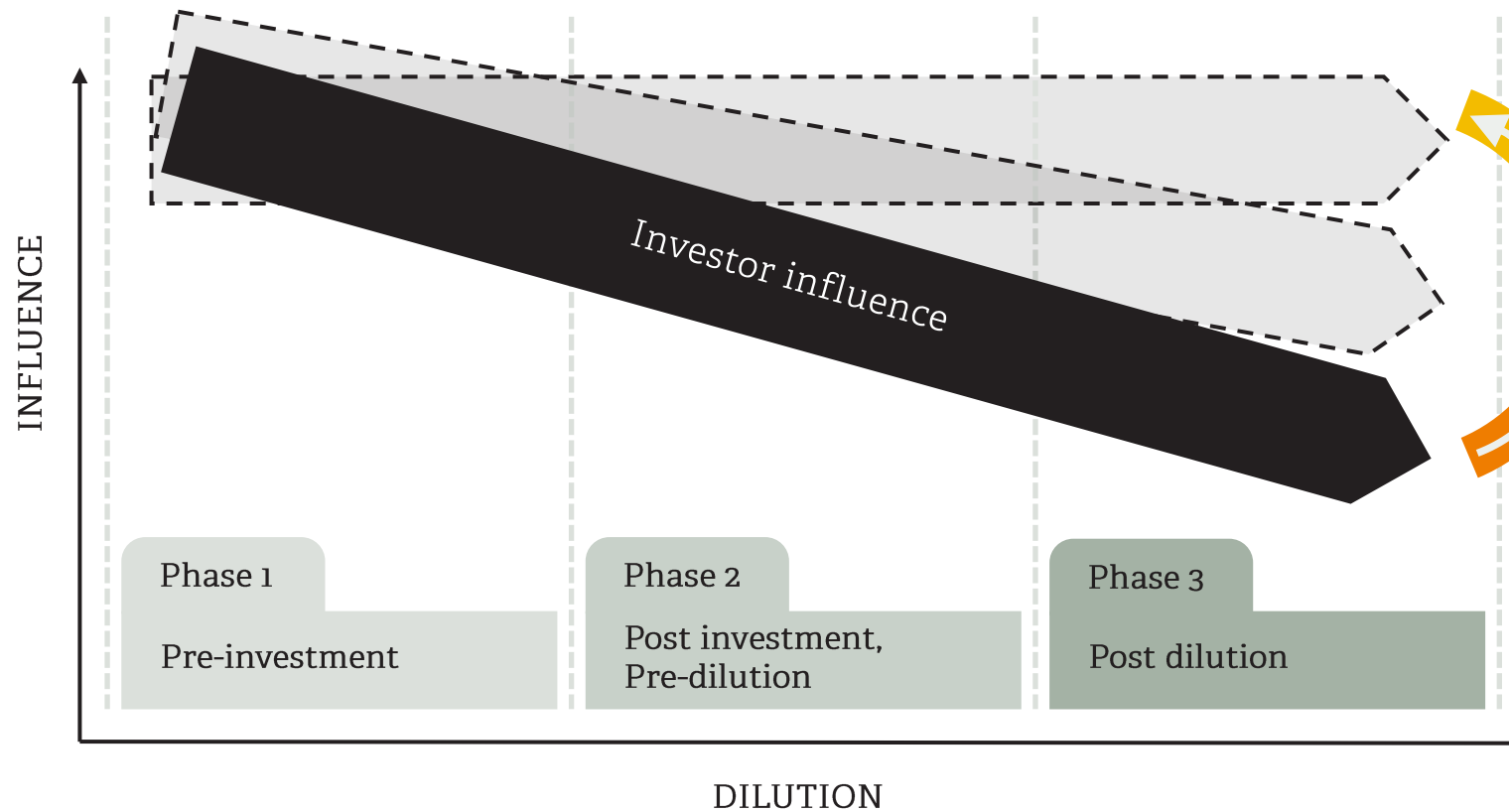
The **3x3 Model of Investor Influence** provides strategies to shape investor influence over investee governance, even as their rights get diluted at subsequent funding rounds.

It comprises:

- » Three strategies of influence (1. Hard Rights, 2. Soft Power, and 3. Ecosystem Leverage).
- » Applied over three distinct investment phases (1. Pre-investment, 2. Post investment, Pre-dilution, and 3. Post dilution).



The 3x3 model of investor influence



An investor's degree of influence generally declines over three investment phases as equity dilutes, but that investor can implement a mix of three strategies to shape its influence, altering the downward trajectory:

- 1 Hard Rights
- 2 Soft Power
- 3 Ecosystem Strategies

Extrinsic factors will affect the potential level of influence on governance

Although VC Fund Managers can and should actively shape their influence on the governance of a startup investee, they need to recognise that **the extent of their influence will be affected by factors outside of their control.**

As startups raise more funding, existing investors may battle for influence alongside new investors who may or may not be aligned on key strategic and commercial matters. Especially on ESG risks and reputational matters, the potential for misalignment is often highest.

In scenarios of a startup's distress or the entry of non-aligned investors, a VC Fund Manager may be faced with difficult choices to prioritise. For instance, which of its requirements is it prepared to waive or drop? Which changes may trigger the need to exit the investment?

The VC Fund Manager should consider prioritising its choices from the pre-investment phase. This could lead to taking proactive steps such as:

- » Setting aside **additional cash reserves** to bridge an investee if needed.
- » Include **exit clauses/ policies** that enable it to extricate itself from an investment when the risk exceeds its tolerance.
- » Encouraging **company practices that strengthen the investment proposition** for later-stage ESG-aligned investors (which would reduce the risk of being forced to accept non-aligned investors).

SHAPE your influence as a VC Fund Manager



VC Fund Managers can shape their influence on a startup investee by deciding on the appropriate mix of three approaches and implementing them – (1) **Hard Rights**, (2) **Soft Power**, and (3) **Ecosystem Leverage** – summarised below in the acronym ‘SHAPE’.

The mix and balance across these approaches will vary by the nature of risks and by the negotiating position of the investors in the case of each investee. They are also affected by the overall resources which a Fund Manager has to allocate across a portfolio. The approaches will likely change dynamically over the three phases of the investment life cycle, hence they are known as the **3X3 Model**.

1	S H	<u>S</u> eek Proportionate <u>H</u> ard Rights	These are formal legal strategies to build and protect influence through agreement. Click ‘view’ to see a list of Hard Rights approaches.	Pages 23-27 or Download ↓
2	A P	<u>A</u> ccumulate Soft <u>P</u> ower	These are strategies to build informal influence <i>inside</i> an investee company over time. Click ‘view’ to see a list of possible Soft Power measures.	Pages 28-33 or Download ↓
3	E	<u>E</u> ngage the Investment Ecosystem	These are ongoing strategies to build <i>indirect influence</i> on an investee company. Click ‘view’ to see how Ecosystem Strategies can help increase Soft Power.	Pages 34-37 or Download ↓



Strategy 1: Seek proportionate Hard Rights

1	S	Seek Proportionate Hard Rights
	H	
2	A	Accumulate Soft Power
	P	
3	E	Engage the Investment Ecosystem

A 'significant minority investor' will typically receive common legal rights at the initial investment.

The threshold for defining a significant stake will vary by market and funding round (around 10% or more of equity is common), as will the nature of the legal rights, which we call **Hard Rights**.



Common Hard Rights include

- » **Right to representation:** This includes rights to a board seat or to observer rights at the board or its sub-committees.
- » **Legal protections:** These include anti-dilution rights, tag/ drag-alongs and right of first refusals (“ROFRs”).
- » **Rights to veto certain material decisions:** For example, new funding events or material changes to a business strategy that would breach an investor’s exclusion list.
- » **Rights to information, audit and reporting:** These allow an investor to receive standard information or require more information or assurance regarding the information in defined cases.

Rights like these can ensure access to information for company monitoring (including ESG performance). This allows a VC Fund Manager to refresh its risk assessment over time. They can also provide rights to influence the strategy and operations of the business and to protect minority shareholders.



However, because Hard Rights **may limit the investee's options in future rounds**, investees are unlikely to agree to enhanced rights unless the overall deal is attractive. It is, therefore, important for VC Fund Managers to seek Hard Rights not for their own sake but proportionate to the risks they see.

VC Fund Managers need to negotiate for Hard Rights at the time of investment which can then be embedded in the comprehensive shareholder agreement, in equivalent legal documentation (e.g. side letters or supplemental agreements) or in the constitutive documents of the company such as its articles or by laws.

The investment instrument may not involve equity at first – see the information box below.

Securing rights with SAFES or Notes

SAFES or Convertible Notes for equity/debt are often used as efficient investment instruments at the early stage. However, SAFES and Notes may carry higher risk than equity in that customary investor rights may be missing or diluted, especially for SAFES, which are, in essence, a promise to convert to equity only if the company raises a new round. However, if red-line issues are identified during the pre-deal assessment, the terms of the SAFES or Notes should be negotiated to address them.



Hard Rights usually diminish with the equity stake of the investor and may disappear below certain equity thresholds.

However, depending on the risks of the investee and the negotiating position of the investor, a VC Fund Manager may be able to follow one or more of these approaches to enhance its Hard Rights:

1.1

Negotiate to extend certain common rights even after dilution below a threshold, for example, keeping rights to certain information even after losing a board seat.

1.2

Negotiate to include enhanced rights, such as:

- Vetoes by shareholders over additional defined issues, e.g. the adoption of certain policies and practices that impact ESG performance.
- Report on business integrity or wider ESG incidents according to a defined protocol and within a defined timeframe beyond dilution.
- Mandatory creation of defined committees related to governance and ESG, or broader risk management - e.g. Audit and Risk Committees and confirm investor participation in them.
- A commitment to follow a defined governance roadmap (see [Guidance Note 2](#)), changes to which require shareholder approval.



1.3

Negotiate to include innovative protections such as terms that:

- allow for investors to suspend drawdowns on investments if certain defined conditions are violated; and/or
- force an exit process whereby an investor can put their shares to other investors or the company at an agreed valuation if there is non-compliance with any of these or if non-aligned investors are brought on board - a form of 'poison pill'.

1.4

Enter shareholder coalitions with like-minded investors on specific topics of mutual concern such as ESG policies, identity of follow-on investors: as per the 'Shareholder coalitions' information box below, these agreements would aggregate and enhance influence of individual investors.

Shareholder coalitions

Certain like-minded shareholders may agree to vote together on certain matters if the majority of these shareholders agree - e.g. some shareholders could agree to vote as a block on whether to accept investment from a potential investor, increasing their influence over what it would be if they voted alone.



Strategy 2: Accumulate Soft Power

1	S H	<u>S</u> eek Proportionate <u>H</u> ard Rights
2	A P	<u>A</u> ccumulate Soft <u>P</u> ower
3	E	<u>E</u> ngage the Investment Ecosystem

This strategy depends on the investor developing and strengthening relationships, policies and practices inside the investee company in order to ensure a flow of information and to help embed good governance in company culture and practices.

Strong, trusted relationships with founders and their leadership teams may give access to information and influence over important decisions even when an investor is no longer on the board or lacks legal rights after dilution.

Unlike with Hard Rights strategies, an investee may change its policies and practices in the future, but good practices established early often prove surprisingly difficult to change.



Encourage and influence the adoption of appropriate strategies and policies that embed good governance

- Encourage the adoption of standard ESG clauses in shareholder agreements or equivalent legal documentation, which will apply to all future investors.
- Maintain a current governance roadmap (see an example in [Guidance Note 2](#)):
 - Ensure portfolio company and board 'buys-in' to adopting a governance roadmap early on, ideally pre-investment.
 - Regularly update and ensure that governance is phased at the right time and becomes part and parcel of the startup as it scales.
 - Ensure a sufficiently appropriate and sophisticated governance model is in place in advance of the next investor phase (so that the company complies with the needs and requirements of an impact investor.
 - Support the appointment of relevant skills and experience on the board (applicable even if an investor is not a board member) for instance, through the appointment of a NED.
- Adopt and embed an appropriate ESG approach:
 - Discuss and agree on ESG standards and benchmarks, which will ensure that companies are held accountable for their ESG performance.
 - Encourage the appointment of non-executive directors with an aligned profile to ensure a balance with future investors, which may push back on ESG requirements. To the extent possible, be involved in the hiring of non-executive directors, including providing feedback on a candidate's expertise and independence.

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2.1

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- Build the corporate culture, tools and processes in alignment with the company purpose and good governance:
 - Support a focus on creating a clear and positively aligned corporate culture from inception, including specific references to relevant values and principles.
 - Implement fair and responsible employee practices around hiring, retrenchment and talent management.
 - Encourage values, principles, and associated practices that would build a culture that is supportive of appropriate ESG adoption.

2.2

Build and leverage relationships across the board and committees

- Work with existing governance bodies and/or compliance officers (or with other like-minded co-investors on such bodies if one does not have representation) to gather information and drive risk management - e.g. be active on Audit and Risk committees and/or ESG committees.
- Drive and influence the board or other committee agendas to discuss and influence certain risk matters (with like-minded co-investors if necessary) - e.g. ESG issues, whistleblowing reports, need for a Compliance hire, etc.



Leverage deep relationships and form coalitions with like-minded co-investors

- Fostering deep relationships with like-minded investors is critical (especially critical when an investor's Hard Rights are diluted) and can:
 - Broaden influence by coordinating activities and networks and developing joint influence strategies.
 - Enable greater access to information through the sharing of information among shareholders to ensure ongoing monitoring, especially in cases where investors lose key information rights post-dilution.
 - More rapidly and effectively respond to warning signs by taking a collective approach (see [Guidance Note 1](#)) or address material changes to the business model that could impact the risk profile.
- This may also include 'sharing' of responsibilities and oversight, especially where investors are resource-constrained across large portfolios or some investors do not have a seat on governance bodies - e.g. board but also related subcommittees.



Offer additional support and resources to implement good governance measures (which investors may co-fund)

- Build value-adding capacity inside your VC fund management team
 - Develop a distinctive competency that investees value – for example, advice on ESG implementation or on communications.
 - Provide ongoing coaching and training to the team to further develop capacity and expertise (e.g. mentoring or encouraging the team to attend relevant ESG training from ESG-aligned LPs).
- Ongoing active portfolio review and technical support
 - Periodic reviews/ assessments/ audits of portfolios by external experts to assist VC Fund Managers with assessing any gaps and opportunities for improvement.
 - VC fund managers are to invest in portfolio monitoring capacity/teams to conduct ongoing spot checks/inspections on the portfolio company's financial reporting and financial controls.
 - Conduct ongoing forensics audit/financial controls review in case of higher risk scenarios (e.g. when early warning signals are detected, in case of company's restructuring, merger and acquisitions, etc.).
- Education, training and coaching of management and board members at the startup on effective governance
 - Ensure a clear understanding of governance KPIs and best practices with ongoing training.
 - Consider external board effectiveness reviews in the case of board misalignment.
 - Bespoke training to the company's founders or CFO/finance teams on spotting fraud red flags and good practices in cash management.



2.5

Leverage public record information to detect early warning signs and monitor company reputation and performance, and emerging risks

- As the company progresses, monitor social media and adverse media coverage (e.g. by setting Google alerts or doing regular adverse media checks) and bring to the attention of management when it is likely to be helpful.
- Conduct due diligence top-ups, and KYC refreshes as a basis for engagement to refresh your risk assessment.
- Leverage any public report that is made available online by the company, e.g., annual reports and ESG/impact reports published on the website.

2.6

Attract and introduce aligned investors to later rounds

- By building good relationships with other investors in the investment ecosystem, you may be able to introduce and attract aligned investors when an investee seeks further funding. See the information box *“Build relationships with aligned potential follow-on investors”* on [page 37](#) for criteria to consider.

2.7

Leverage existing networks for information

- Investors should leverage their networks to conduct regular reference checks on the company and management (especially in light of any issue) or reference checks on new investors, board members or key stakeholders the company is engaging with, for instance.



Strategy 3: Engage the Investment Ecosystem

1	S	<u>S</u> eek Proportionate <u>H</u> ard Rights
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2	A	<u>A</u> ccumulate Soft <u>P</u> ower
	P	
3	E	<u>E</u> ngage the Investment Ecosystem

Investors should **engage influential organisations and players across the investment ecosystem** and may be able to mobilise them to indirectly influence portfolio companies.

Ecosystem players respected by a startup investee or which are influential in the VC industry can help exert indirect pressure on an investee (or on co-investors), provide useful sources of information, or supply updated ESG frameworks, thus helping to protect the interests and influence of an existing investor as its stake dilutes.



These external organisations may include:

- » Other like-minded investors who may be future follow-on investors.
- » LPs and fund of funds (including DFIs).
- » Industry associations, regulators, entrepreneur organisations, and industry thought leaders.

Specifically, an investor could:

3.1

Support or organise dedicated training and development programs such as:

- programs which foster leadership development among founders and senior managers;
- board governance events for founders and board members where governance experts are invited to provide perspectives and engage.



3.2

Foster deep relationships across the investor ecosystem and mobilise others to support positive governance practices and codes:

- Seek out aligned investors – see the information box “*Build relationships with aligned potential follow-on investors*” on [page 37](#) for pointers on what to look for.
- Work with fund of fund investors (including DFIs), that may influence underlying VC strategies, and indeed require specific ESG requirements for their investors.
- Work with industry bodies or networks which promote good practices.

3.3

Deepen relationships with relevant government agencies and other regulatory bodies in order to clarify, understand, and potentially contribute to new policies and regulations that could benefit the market.

3.4

Actively contribute and publicly share thought leadership content on governance topics that may help educate and influence investees (e.g., how to professionalise the board of directors and how to build governance, which adds value).



Build relationships with aligned potential follow-on investors

It is very useful to develop a close network of aligned investors who could invest in your portfolio companies in later rounds. Using reference checks from LPs, DFIs and other Fund Managers, you should therefore, identify, build and mobilise networks of potential investors, considering these factors:

Funding	Will this investor have the firepower for future rounds? Do they have a strong reputation, network, and credibility with other VCs to help raise the next round?
Expertise, experience, network, and track record	Is this consistent and aligned with your mandate, especially regarding good governance and ESG?
Organisational capacity	Does the investor have broad resources or network (a platform and community) to leverage in case of challenges at an investee? This is not necessarily about investor size – even a small Fund Manager may have great leverage.
Commitment to ESG	What is the investor's commitment and track record of supporting good governance? Who are the LPs? Do they include any reputable ESG investors or DFIs? What do they say about ESG?
Involvement	Is their approach to investees hands off, too meddlesome (e.g. they require too much reporting, etc) or usually the right balance?




Phase 1: Pre-investment phase



During due diligence (“DD”), an investor must assess the risks and governance issues arising at the different stages of development of the startup (see [Stagefinder in GN2](#)) and as a result, decide on which strategies to adopt to build and maintain its influence based on its own risk appetite and on an assessment of the risks of the investee.

An investor must determine its risk appetite based on its values and processes in alignment with its LP’s risk appetite. This involves setting ‘red-lines’ for risks which it would not accept (such as related to ESG, business integrity, business model), and taking into account possible changes in the market.

The firm’s approach to risk should be reflected in its Limited Partnership Agreement (LPA) and related governance documents.



We will now consider the approaches across each Phase in turn.

To assess investee risks, a VC Fund should carefully prioritise which **Hard Rights** are essential to protect their position; and which **Soft Power** strategies could help offset an inability to negotiate Hard Rights, and if so, how much effort to exert on them.



Phase 1: Pre-investment phase



During due diligence ('DD'), an investor must assess the risks and governance issues arising at the different stages of development of the startup (see [Stagefinder in GN2](#)) and as a result, decide on which strategies to adopt to build and maintain its influence based on its own risk appetite and on an assessment of the risks of the investee.

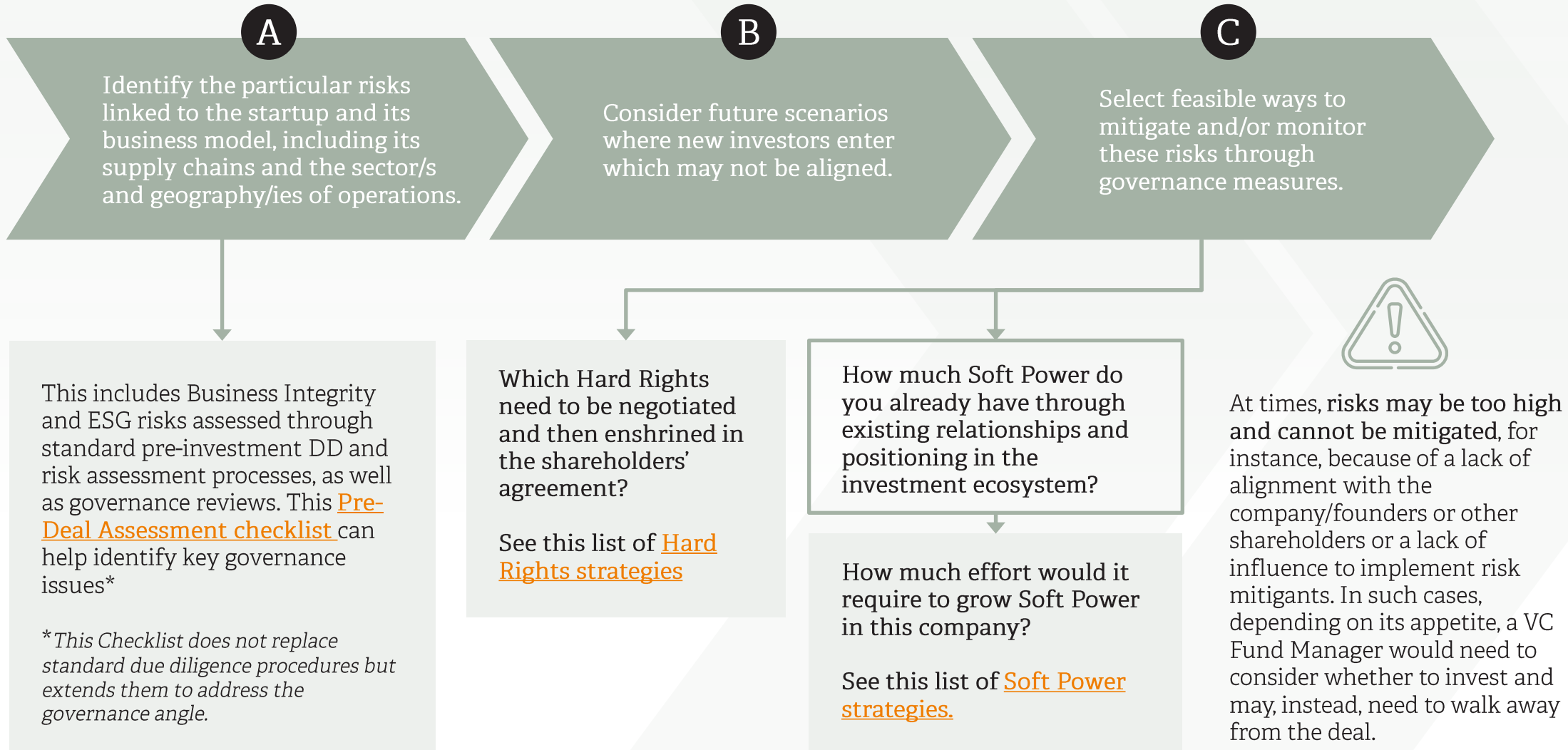
An investor must determine its risk appetite based on its values and processes in alignment within its LPs' risk appetite. This involves setting 'red-lines' for risks which it would not accept (e.g. risks related to ESG, business integrity, business model), and taking into account possible changes in market conditions or new ESG and legal frameworks.

The firm's approach to risk should be documented as part of the fund mandate in its Limited Partnership Agreement (LPA) and related governance documents.

To assess investee risks, a **VC Fund Manager** can follow the steps shown on the next slide to carefully prioritise which **Hard Rights** are essential to protect their position, and which **Soft Power** strategies could help offset an inability to negotiate Hard Rights, and if so, how much effort to exert on them.



Steps a VC Fund Manager can follow to assess investee risks



Phase 2: Post investment, pre-dilution

During this phase, an investor may have a strong legal position based on the Hard Rights it has negotiated at Phase 1: its shareholding likely stands at the highest level it may ever be. However, exercising its legal power while building up Soft Power requires capacity and resources, and the investor needs to decide how much to invest in Soft Power strategies. The issues at this stage are shown for each strategy below:

		Phase 2	Guidance
S	<u>S</u> eek Proportionate <u>H</u> ard Rights		In this phase, the investor has to consider when and how to use the Hard Rights it has secured in the first phase. If these include a board seat, then the investor can use that seat to build Soft Power while also instituting good governance practices which may endure beyond dilution, such as regular board effectiveness reviews and evaluations.
H			
A	<u>A</u> ccumulate Soft <u>P</u> ower		During this phase, the investor should prepare for dilution in future by building trusted relationships with founders, co-investors, other directors and executives. Especially if a VC Fund Manager has multiple points of contact with an investee, it is worth mapping the nature and extent of relationships within the company. In light of their rights being diluted, investors may decide to invest more time in developing certain relationships.
P			
E	<u>E</u> ngage the Investment Ecosystem		This involves an ongoing conscious effort to build relationships and influence across the investment ecosystem, for example, with other aligned investors who may invest later, DFIs, fund-of-funds, associations, regulators, and support providers in the ecosystem. These relationships may be helpful when Hard Rights are reduced or Soft Power may be limited.

Phase 3: Post dilution

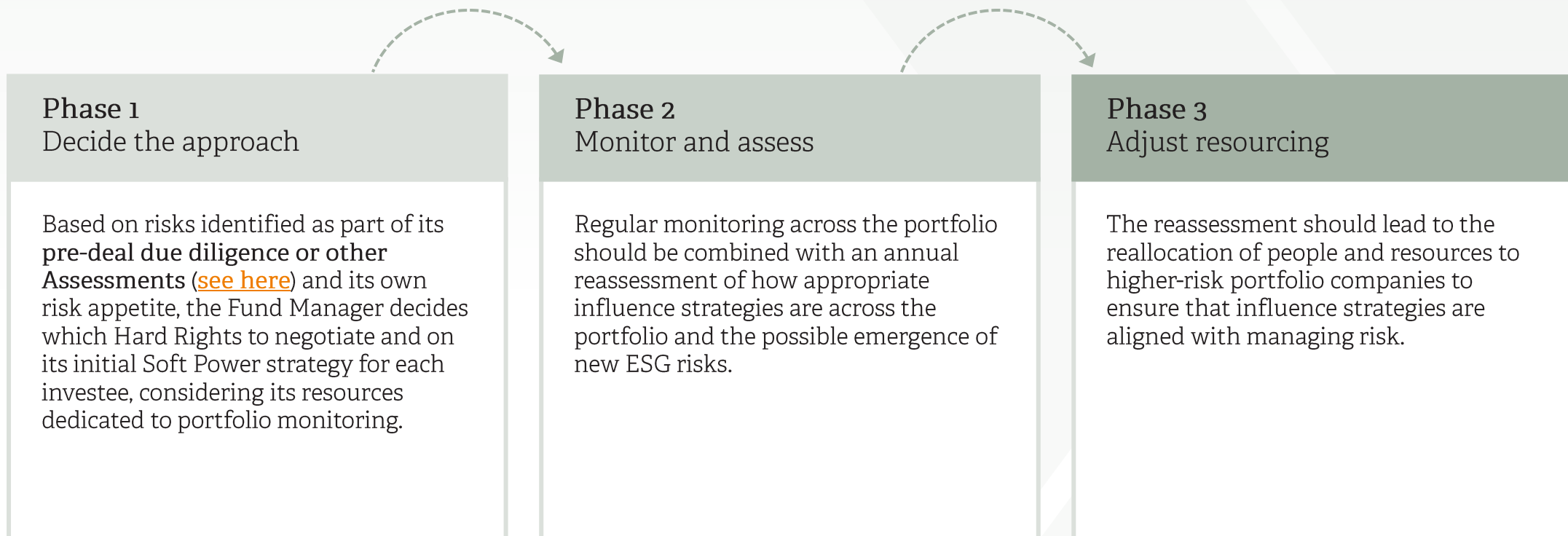
During this phase, an investor may have extended Hard Rights in place, which continue to allow access to information, even if it has lost its right to a board seat. These rights need to be monitored and enforced if needed. Even as Hard Rights diminish, it may nonetheless be possible for the investor to maintain its Soft Power at this phase through targeted engagement with co-investors and through maintaining contact with founders and some directors, especially if they have a trusted skill or perspective to offer.

		Phase 3	Guidance
S	Seek Proportionate Hard Rights		In this phase, further Hard Rights are usually not available, but an investor can make use of secured rights to information or incident reporting to monitor the investee company and may be able to exert hard influence through an investor coalition built in the previous phase.
H			
A	Accumulate Soft Power		By spending time maintaining contact with the founders and management team of the investee company, or other stakeholders such as other shareholders, an investor may still be able to glean further information and offer timely and trusted advice, which may influence decisions.
P			
E	Engage the Investment Ecosystem		Engagement with the wider investment ecosystem around an investee in its main jurisdiction and/or sector will yield information and may create leverage points around key issues as they arise.

A portfolio approach to influence

So far, we have explored investor influence through the life cycle of an individual investment. However, VC Fund Managers also have to allocate scarce resources across their entire portfolio and ensure risk-based monitoring.

A portfolio approach to influence requires that a Fund Manager (1) assesses the risks and needs across its entire portfolio of companies relative to the resources available to that investor and then (2) decides on an appropriate mix of hard and soft approaches across its portfolio, including leveraging further resources and influence from coalitions with like-minded investors and ecosystem participants such as DFIs.



Phase 1 Decide the approach

The total human and financial resources available should shape the approach.

For example, even if board seats or observer rights are on offer, a Fund Manager may choose not to take them all up directly because it can allocate scarce partner time towards higher-risk situations.

Alternatively, they may nominate independent directors with expertise and time into the seats, though this will likely incur financial costs.

Phase 2 Monitor and assess

At this stage, the Fund Manager is unlikely to gain new Hard Rights, but it can build its Soft Power to influence investees towards entrenching good governance practices or ensuring information rights.

Identifying common needs and engaging the ecosystem around a group of investees may also build external forms of Soft Power.

Phase 3 Adjust resourcing

A fund manager may be able to maintain influence even with equity dilution by investing its resources in accumulating Soft Power and pushing to renegotiate certain Hard Rights as part of follow-on rounds, especially when the company faces new material ESG risks.

However, if these strategies have not worked or risks become unmanageable or too high because of the company's inability to implement additional risk mitigants, the new non-aligned investor, or other new ESG risks, the Fund Manager may need to consider other appropriate actions, including its exit options, legal action, or approaches to regulators.

Approaches for typical scenarios faced by investors



Now let us return to the mini-scenarios raised at the beginning to consider how a VC firm can SHAPE influence as an investee. View each scenario to see what approach may be taken.

Phase 1

Pre-investment

Scenario 1
Assessing the risks
[Page 46](#)

Phase 2

Post investment, pre-dilution

Scenario 2
Managing new risks
[Page 47](#)

Phase 3

Post dilution

Scenario 3
Adjusting to post dilution
[Page 48](#)

Scenario 4
Acting on new information
[Page 49](#)



Scenario 1: Assessing the risks

Phase 1

A startup is seeking to raise Series A funding. It has an attractive digital business model but operates in a country with a challenging business environment. Due to its high level of government interaction, its activities carry heightened corruption risk. None of the current shareholders are ESG-aligned investors.

Phase 2

Phase 3

Recognising that, even if it acquires a substantial stake in Series A, its influence will dilute over time, how might a VC Fund Manager mitigate possible future ESG-related risks while ensuring it still participates in this funding round?

One approach to this scenario

Because of the risk, the VC Fund Manager decides to negotiate for an enhanced set of Hard Rights beyond a board seat only, including:

- » The right to request an audit ESG assessment on company activities even after dilution.
- » The requirement to provide incident reporting on BI and ESG even after dilution.
- » A requirement that the board revisit the governance roadmap to address gaps identified and provide the updated roadmap to shareholders.

In addition, the VC Fund Manager engages with the company management, providing support for the adoption of good ESG practices on the basis that this will make future fund raising easier with aligned investors. This may be done through a formal process, such as hiring an independent consultant to assist the company, or through a more informal process by the VC Fund Manager itself, by spending time with and guiding management. These soft strategies may be embedded in the governance roadmap and budget.

As a result, even when it loses the right to the board seat at later rounds, the VC Fund Manager will still receive the information it requires to ensure ongoing risk monitoring and report to its LPs.

View more [Hard Rights](#) and [Soft Power](#) options.



Scenario 2: Managing new risks

Phase 1

The VC Fund Manager succeeds in getting a board seat after leading the startup's Series A round.

Although new investors enter the cap table at Series B, the Fund Manager retains its board seat because it also participated in the round, keeping its stake above the 10% threshold.

Phase 2

However, the company is now struggling to get traction. It proposes to pivot its previously digital-only business model by starting to invest in physical infrastructure and equipment with a substantial footprint.

Phase 3

How can the VC Fund Manager monitor the risks and mitigate the impact of further dilution?

An approach to this scenario

Fortunately, the VC investor has already negotiated Hard Rights to ESG reporting and incident reporting, which enables it to monitor the risks.

However, in addition to strengthening its position for the future, this VC investor could:

- » Use its position on the board or board sub-committees to oversee changes in business model and related risks and advocate new indicators to track as part of ESG metrics.
- » Engage other co-investors to build a coalition which supports a reporting approach that evolves commensurate to the risks.
- » Offer technical assistance to management to design a risk-based reporting system in line with good practice.
- » Offer to introduce managers to experts who understand the risk issues associated with acquiring physical infrastructure.

View more [Soft Power](#) building options.



Scenario 3: Adjusting to post dilution

Phase 1

After regaining traction, the startup company concluded a successful Series C round in which large new growth investors entered its cap table. The VC Fund Manager that led two earlier rounds has its stake diluted below 10%, and it has lost its board seat. To maintain its growth momentum, the company proposes to launch new regulated financial products alongside its existing offering.

Phase 2

Phase 3

How can the VC Fund Manager continue to get access to information needed to understand the risks involved and compile the reports that its LPs require?

An approach to this scenario

The move into a new regulated sector triggers new considerations and risks and may boost the company up to a higher stage of governance evolution in which new measures are indicated (see [Guidance Note 2](#)). Fortunately, the company has built-in enduring reporting requirements which allow the VC Fund Manager to continue to monitor the new risks, even if it is not on the board anymore. However, Soft Power approaches like these may help to mitigate the risk:

- » Meet with aligned co-investors to jointly propose the adoption of new risk-based measures, including reporting on the new line of business and guiding the company to implement a new compliance programme to target product-related risks and new regulatory compliance requirements.
- » Engage the Chair of the Audit Committee to establish whether the skills and composition of the committee need to be supplemented to oversee new compliance issues and requirements.
- » Offer to connect the CEO or CFO with an external expert on the topic of regulation in this sector and guidance on how to ensure good regulatory reporting to relevant authorities.
- » Stay in touch with the founder/CEO on the basis of a good relationship built prior to this to keep in touch with developments in the business.

View more [Soft Power](#) options.



Scenario 4: Acting on new information

Phase 1

The startup company is under pressure from its new investors to build momentum further. It is now considering placing substantial orders for equipment from a large new supplier, which is located in a country sanctioned for its labour market practices but offers attractive pricing.

Phase 2

Phase 3

Now that the VC Fund Manager is no longer on the board and has only a minority stake, what can it do to influence the decision about the supplier?

An approach to this scenario

In its pre-investment negotiation, the VC Fund Manager secured Hard Rights that any change to the company's ESG policy would require board approval. The policy requires that suppliers be screened for sanction violations and forced labour issues, although it gives no veto rights over appointing a particular supplier. If there is the prospect that the policy may be overridden, the VC Fund Manager could bring this issue to the attention of other investors and the board of directors, and once the decision is taken, the Fund Manager could request an investigation into how the policy was applied in this case.

However, if these approaches do not resolve the situation, the VC Fund Manager may be forced to consider exit options. If there was a protective clause in the shareholders' agreement that would allow it to sell its shares to an investor who violated the VC Fund Manager's policies in defined areas, this could allow it to exit.

View more [Hard Rights](#) options.





GoHardy, India

Now, let us explore how these strategies SHAPE influence an investee and how they may play out through a full case study of a startup, which you will have encountered before in this series of Guidance Notes.



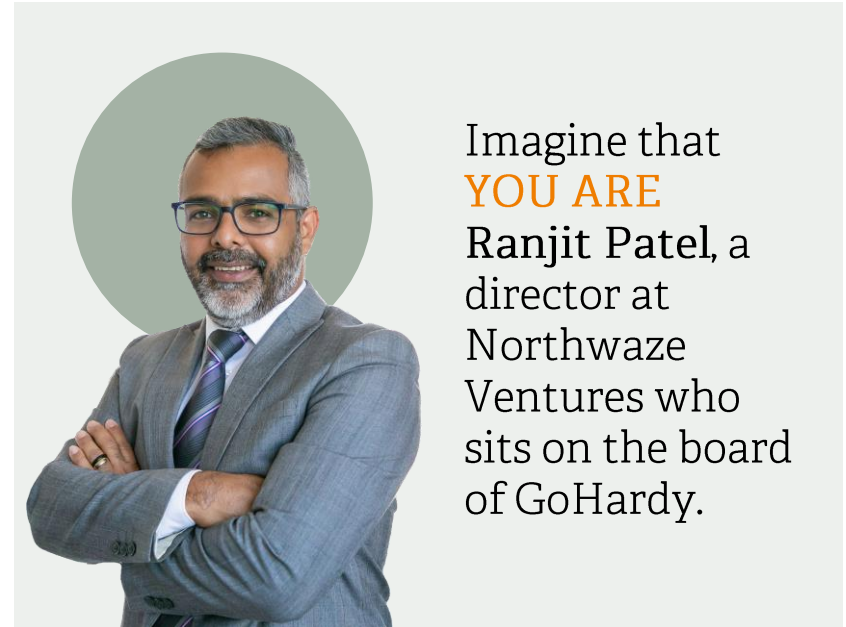


GoHardy is a B2B e-commerce platform for household hardware, which was started in 2019 by two co-founders in India. In Guidance Notes [1](#) and [2](#) in this series, you may have read the story of how Northwaze Ventures, an Indian VC Fund Manager, invested in GoHardy's Series A. As a result, Northwaze gained the right to appoint a director to its board. Ranjit Patel, a director at Northwaze, has filled the seat since then. If you haven't seen those notes, you can still pick up the story here.

As background, GoHardy faced some early challenges in its governance process, but it has improved since a Series B round: a major new international investor joined the board, and a strong independent chair was appointed.

Board of GoHardy	<p>Atul Nayak - Founder CEO</p> <p>Amit Basak - Executive Director, CTO and co-founder</p> <p>Ranjit Patel - Director at Northwaze Ventures</p> <p>Julie Smith - Partner in E-Commerce Ventures (ECV), which came in as a major shareholder through the B round.</p> <p>Raj Kapur - Independent new Chair</p>
SMT	<p>Meera Shah - CFO</p>
Potential Investor	<p>Vijay Rao - The head of a venture arm of an Indian conglomerate in the construction sector which has signed a term sheet to invest.</p>

Instructions



Imagine that **YOU ARE** **Ranjit Patel**, a director at Northwaze Ventures who sits on the board of GoHardy.

Continue



GoHardy's cap table over time

In the table below, you will see how the holdings of the different investors have changed over time up to the end of the Series B round. Northwaze's stake is highlighted – it has already been diluted from its peak after the Series A to hold around 11.9% now. Further dilution would likely place Northwaze below the 10% threshold required to nominate a director to a board seat.

	Pre-seed	Seed	A	B
Co-Founders	88%	65.1%	49.5%	40.1%
Angels/Pre-Seed VC	12%	8.9%	6.7%	5.5%
Northwaze Ventures		8.0%	14.6%	11.9%
Other seed VCs		12.0%	9.1%	7.4%
Oriyon Partners			6.7%	7.1%
Other A VCs			3.8%	3.1%
ECV				11.8%
Other B VCs				3.4%
ESOP		6.0%	9.6%	9.8%

Setting the scene

Read the story in which Ranjit considers how best to exercise influence in different circumstances. The story has been divided into a series of four audio clips for which transcripts have been provided.

Ranjit is preparing for an upcoming GoHardy board meeting.

Read the transcript for the **first audio clip** and answer the questions which follow. Take some time to consider your answer for each question before moving on to the next page and revealing the correct answer.

Continue



1 Audio 1 of 4

TRANSCRIPT

Ranjit Patel looked up from his tablet and rubbed his eyes. He had spent hours reading the long board papers that he had received in advance of the GoHardy board meeting, which was in a few days' time. The board pack was full of KPI dashboards and sets of financials, which showed that GoHardy's business continued to grow, although not as fast as the founder, Atul, had projected. Because the business continued to lose money as it pursued growth, the cash position was growing tight. The cash runway was now down to four months at current burn rates. This was why the business needed a Series C funding round.

'At least I know I can now place some reliance on GoHardy's reporting,' thought Ranjit. Only two years earlier, when GoHardy had begun to prepare for its Series B round, accurate and appropriate reporting was in short supply. Ranjit remembered the fateful board meeting in which the CEO had presented a set of annual financial statements for approval, which invited many questions. His suggestion back then to set up an audit committee had fallen on deaf ears. Neither the co-founders nor the chair at that time had thought that this was a priority compared with pursuing expansion and further fundraising. Fortunately, however, the lead investor, which had come in through the Series B round, had forced certain changes at GoHardy, which had markedly improved its governance.

The lead investor for Series B was a large multistage international fund called E-Commerce Ventures or ECV. ECV was known as a hard-nosed commercial VC fund with a ruthless focus on pushing its investments to grow in order for ECV to exit quickly. ECV had taken up a 15% stake, which gave them a board seat. Julie Smith, an ECV partner who had substantial experience in scaling e-commerce businesses elsewhere, although none before in India, had taken up the seat. Since Northwaze's stake had remained above the 10% equity threshold, Ranjit had remained on the board. He had also been appointed to the Audit and Risk Committee when it was formed. He took care to get to know Julie and hosted her on visits to India for board meetings.



1

Audio 1 of 4

TRANSCRIPT

As part of ECV's requirement to strengthen the board, the first chair, a family friend of the founders who was out of his depth, had to step down. In his place, the leading shareholders had agreed to appoint an independent and experienced chair. Raj Kapur was a former senior partner in the Indian practice of a large accounting and consulting firm. He had substantial board experience. Ranjit had been the one who identified and proposed Raj to the others. He was very pleased with the outcome so far: the founders seemed more willing to take financial controls and reporting seriously. The new chair, Raj, managed meetings so that different views were taken into account. Usually, a clear decision emerged. It also helped that, after a bumpy start, Meera Shah, the CFO who had been hired just over two years ago, had turned out to be a strong voice of financial reason. She had instituted more extensive reporting frameworks. Ranjit had intentionally cultivated a trusted relationship with her, and she often reached out to him for his advice. Ranjit had also become more active in attending events organised by the E-Commerce Association since he gained perspective on developments in the wider sector and had made some useful contacts.

All of these positive developments risked being overshadowed by the term sheet proposal now before the GoHardy board. Atul, the CEO, led the process of searching for a lead investor who was willing and able to write a check of the magnitude required, given the burn rate of the business and the valuation range. Meanwhile, the general business environment had not improved. Governance scandals in the Indian startup ecosystem had chilled the interest of larger foreign investors, and GoHardy's latest growth numbers didn't have quite the shine of a year ago. However, in the latest board pack, Atul reported that he had finally found the ideal investor and sought board approval to proceed to close the round.





1 Audio 1 of 4



Read the transcript on Page 54.

Question 1

Which statement best defines the external funding ecosystem at this time?

Thriving with lots of new investors.

Staying level.

Under pressure.

Not clear.

Continue 



At this time, the external funding ecosystem can be best defined as 'Under Pressure'.

The funding environment and scandals had chilled investor interest.

Continue



Question 1

Which statement best defines the external funding ecosystem at this time?

Thriving with lots of new investors.

Staying level.

Under pressure.

Not clear.

1

Audio 1 of 4



Read the transcript on Page 54.

Question 2

Which statement best describes GoHardy's position as it approaches its Series C round?

Strong.

Relatively weak.

Not clear.

Continue





GoHardy's position as it approaches its Series C round can best be described as 'relatively weak'.

It has a short runway combined with urgency to fundraise in a challenging environment.

Continue



Question 2

Which statement best describes GoHardy's position as it approaches its Series C round?

Strong.

Relatively weak.

Not clear.



1 Audio 1 of 4



Read the transcript on Page 54.

Question 3


Which statement best describes the governance at GoHardy relative to two years before?

Improving.

The same.

Declining.

Can't tell.

Continue 



The governance at GoHardy relative to two years before can best be described as 'improving.'

The case describes the appointment of an experienced chair and improvements in controls and reporting.

Continue



Question 3

Which statement best describes the governance at GoHardy relative to two years before?

Improving.

The same.

Declining.

Can't tell.

1

Audio 1 of 4



Read the transcript on Page 54.

Question 4

Which of these factors had contributed to the changes in governance? (Choose all that apply)

Appointment of a new experienced chair.

Set up of an audit committee.

A new forceful shareholder on the board.

A capable CFO.

Continue





All of these factors had contributed to the changes in governance.

Continue



Question 4

Which of these factors had most contributed to the changes in governance? (Choose all that apply)

Appointment of a new experienced chair.

Set up of an audit committee.

A new forceful shareholder on the board.

A capable CFO.

1

Audio 1 of 4



Read the transcript on Page 54.

Question 5

Which of the following statements is true of Ranjit's Hard Rights at GoHardy? (Choose all that apply)

He still has Hard Rights through his board seat.

His fund still has above 10%, a threshold for shareholder rights.

He identified the new chair.

He gets on well with the CFO.

Continue





Ranjit still has Hard Rights through his board seat retained through the B round, and his fund still has above 10%, which is the threshold to appoint a board member.

Identifying the new chair is Soft Leverage.

How well he gets on with the CFO has not been disclosed.

Continue



Question 5

Which of the following statements is true of Ranjit's Hard Rights at GoHardy? (Choose all that apply)

He still has Hard Rights through his board seat.

His fund still has above 10%, a threshold for shareholder rights.

He identified the new chair.

He gets on well with the CFO.

1

Audio 1 of 4



Read the transcript on Page 54.

Question 6

Which factors have boosted Ranjit's **Soft Power** at GoHardy?
(Choose all that apply)

His firm has a 10% stake.

He has got to know the new ECV director.

He now attends meetings of the E-Commerce Association.

The CFO reaches out to him for advice.

Continue



He has gotten to know the new ECV director and his relationships with co-investors support Soft Power. The CFO reaches out to him for advice, which is another factor that has boosted his Soft Power. Trusted relationships with the executive team beyond the founder alone can increase information flow and informal influence.

The 10% stake his firm has gives legal rights which is considered part of Hard Rights not Soft Power. The fact that he now attends meetings of the E-Commerce Association may help in the future but is described here as a separate external strategy.

Continue



Question 6

Which factors have boosted Ranjit's Soft Power at GoHardy?
(Choose all that apply)

His firm has a 10% stake.

He has got to know the new ECV director.

He now attends meetings of the E-Commerce Association.

The CFO reaches out to him for advice.

Ranjit's concerns

Ranjit has concerns regarding a potential investor, which has signed a term sheet to lead investment. He needs to consider his stance before the board meeting.

Read the transcript for the **second audio clip** and the four questions which follow. Take some time to consider your answer for each question before moving on to the next page and revealing the correct answer.

Continue



2 Audio 2 of 4

TRANSCRIPT

The name of the lead investor was BOB Investments Pvt Ltd. They had signed a term sheet indicating their willingness to take up the entire Series C tranche – all 75 million US Dollars of it – on a pre-money valuation of 300 million US Dollars. This would secure BOB Investments a hefty stake of close to 20% and also a board seat. Ranjit did some quick mental calculations, which confirmed that as a result, Northwaze's stake would be reduced to just under the 10% threshold. He would likely lose his board seat if this deal went through.

According to the board papers, BOB Investments was certainly good for the money. It was the investment arm of a family holding company with a controlling interest in a large listed construction and property development group called BOB Construction. BOB Construction was well known in parts of India for large-scale residential development projects. The Rao family had founded the company 40 years before. As urban India blossomed, BOB Construction thrived and became the foundation of their extensive wealth. The investment arm was run by Vijay Rao, the younger son of the founder. He was known to be an aggressive investor in sectors adjacent to the core construction business. His strategy was to take a minority stake in a business to test out the fit of the business within the group; if it worked well, then BOB Investments would buy out the other interests and integrate the company into the BOB Construction group. According to Ranjit's network, Vijay Rao was not known for his sympathy for ESG issues and, indeed, showed little direct interest in the governance of investee companies as long as they delivered results. Only if the alignment with the BOB Group proved strong would he step in and take a more directive approach.

GoHardy's growing hardware business was a good potential fit with residential development. BOB Group's homeowners needed to maintain and repair their new houses and apartments, and the growing army of plumbers, electricians and carpenters who bought their supplies using GoHardy's platform could benefit from the connections and promotion. BOB Investments didn't seem to balk at GoHardy's valuation, which Ranjit considered very generous in the current circumstances. BOB Investment's substantial cash injection and its business linkages could give GoHardy the big boost it needed. And what's more, it also opened a potential path for current GoHardy investors to exit in future: this was a factor which Ranjit, whose fund had three years remaining, could not ignore.



2 Audio 2 of 4

TRANSCRIPT

So, there was much to like about this deal, and what's more, there weren't any others on the table right now. But Ranjit felt uneasy. His internet searches of the BOB Group had called up numerous references in local newspapers to ongoing labour disputes with the construction company: working conditions were reportedly unsafe, leading to high rates of injuries onsite. There were also complaints that BOB received planning and construction permits much more quickly than other firms in the sector. There was no proof that overt corruption had been involved, but the news articles made Ranjit uncomfortable, suggesting that there could be misalignment with the new investor on ESG matters.

Ranjit felt conflicted: Did the questionable ESG track record of the parent company also reflect on the investment arm, or was he too sensitive? He was all too aware that Northwaze Ventures' mandates with several of its LPs required it to maintain active ESG policies, including Anti-Bribery and Corruption procedures. If the board approved this investment, the Northwaze stake would dilute to below 10%, so he would potentially lose his board seat and, with it, likely also his growing influence in the company.

He realised that he was likely in a minority on the board with his concerns: Atul clearly wanted the deal since it provided badly needed cash. Ranjit sensed that Julie from co-investor ECV would probably leap at the potential exit opportunity. Only the Chair, Raj, might be open to persuasion if he knew of the BOB Group's reputational issues. But Raj was usually firm in applying his fiduciary duty to determine what was best for the company, and he was acutely aware of the dwindling cash position. So, Ranjit knew that he needed to think carefully before the board meeting about his stance on the BOB Investments deal.





2

Audio 2 of 4



Read the transcript on Page 69.

Question 1

Which of these statements describes the financial appeal of the proposed investment by BOB? (choose all that apply)

BOB Investments was willing to agree to a high valuation.

BOB Investments offered a possible path to buyout and exit.

GoHardy may benefit from the relationship with BOB Group's core business to grow its market share.

None of these options apply.

Continue





These three options all describe the financial appeal of the proposed investment by BOB.

Continue



Question 1

Which of these statements describes the financial appeal of the proposed investment by BOB? (choose all that apply)

BOB Investments was willing to agree to a high valuation.

BOB Investments offered a possible path to buyout and exit.

GoHardy may benefit from the relationship with BOB Group's core business to grow its market share.

None of these options apply.

2

Audio 2 of 4



Read the transcript on Page 69.

Question 2

Which of the following were Ranjit's concerns about the deal with BOB? (Choose all that apply)

BOB Investments had no competence in e-commerce.

The rumours about expedited access to permits raised reputational and misalignment risks.

The labour issues at BOB Group raised questions about its ESG approach.

He would lose his board seat at the next round.

Continue



Ranjit was concerned about the rumours about expedited access to permits, raising reputational and misalignment risks. This could affect Northwaze's standing with current and future LPs. He was also concerned about the labour issues at BOB Group, which raised questions about its ESG approach, as Northwaze had ESG mandates from its investors.

He was not concerned that he would lose his board seat in the next round. He seemed to accept this as inevitable if he was not able or willing to invest more.

Continue



Question 2

Which of the following were Ranjit's concerns about the deal with BOB? (Choose all that apply)

BOB Investments had no competence in e-commerce.

The rumours about expedited access to permits raised reputational and misalignment risks.

The labour issues at BOB Group raised questions about its ESG approach.

He would lose his board seat at the next round.

2 Audio 2 of 4



Read the transcript on Page 69.

Question 3

Which one statement best describes the conflict which Ranjit faces?

As a director, he is bound to seek the best interests of all shareholders, but his fund has a particular interest in the ESG practices (including ABC and ethical practices) at its investees.

As a director, he could be personally liable if GoHardy adopted corrupt practices.

GoHardy needs the money, but Ranjit's personal principles are at stake.

How to get BOB Investments' money without having Vijay Rao on the board.

Continue



As a director, Ranjit is bound to seek the best interests of all shareholders and has both a fiduciary obligation to the company and an interest as a shareholder.

The statement about potential liability is true, but there is no indication that GoHardy has adopted corrupt practices in this case.

It is not just his personal principles at stake but also the mandates of his fund and potentially his fiduciary duty.

Vijay's influence is described as erratic, but Ranjit doesn't seem personally opposed to him as opposed to the overall influence of BOB Investments, whoever the new director is.

Continue



Question 3

Which one statement best describes the conflict which Ranjit faces?

As a director, he is bound to seek the best interests of all shareholders, but his fund has a particular interest in the ESG practices (including ABC and ethical practices) at its investees.

As a director, he could be personally liable if GoHardy adopted corrupt practices.

GoHardy needs the money, but Ranjit's personal principles are at stake.

How to get BOB Investments' money without having Vijay Rao on the board.

2

Audio 2 of 4



Read the transcript on Page 69.

Question 4

Which of these might be good options for Ranjit to take towards the proposed deal?

To insist on retaining his board seat even after dilution.

To persuade Atul to withdraw the proposal.

To lobby other directors also to oppose the deal.

To propose additional safeguards to put in place.

Continue



To propose putting additional safeguards in place is a good option and is what he does.

To insist on retaining his board seat even after dilution is unlikely to work.

Atul is clearly behind the deal, and given the cash crunch, he is unlikely to withdraw it because of the concerns of a single investor.

Lobbying other directors to oppose the deal may work, although it seems unlikely if management is in favour and other directors are disposed to agree.

Continue



Question 4

Which of these might be good options for Ranjit to take towards the proposed deal?

To insist on retaining his board seat even after dilution.

To persuade Atul to withdraw the proposal.

To lobby other directors also to oppose the deal.

To propose additional safeguards to put in place.

Later in the year

Read the transcript for the **third audio clip** to find out what was decided at the board meeting and the effects of the decisions a few months down the line.

There are four questions in this section. Take some time to consider your answer for the questions before moving on to the next page and revealing the correct answer.

Continue



At the board meeting, Ranjit raised his concerns about the alignment of BOB Investments and questioned whether allocating BOB Investments a board seat would enhance the board's functioning. Julie and Raj, the Chair, seemed somewhat sympathetic, especially since it meant that the hard-won progress to improve governance at GoHardy over the past few years was at risk of being eroded. However, since no other funding options were on the table, the GoHardy board duly approved the term sheet.

Fortunately, having realised beforehand that this outcome was likely, Ranjit had prepared some proposals, which he had discussed in advance with CEO and founder Atul and the Chair, Raj. Atul had been initially reluctant to accept any more governance constraints but had agreed to support them when Ranjit explained how these measures might also protect him from arbitrary influence at the whim of a new shareholder. First, he proposed that the board affirm GoHardy's ESG reporting policy, which they did, and they agreed that all shareholders would be consulted before any changes were made to ESG policy. The board also agreed to two additional measures. Firstly, shareholders' rights should be extended to ESG incident reporting indefinitely, rather than phasing out on dilution below 10%. And secondly, to provide existing shareholders with access to the materials prepared for meetings of the Audit and Risk Committee.

Although Ranjit then stepped down from the board and the Audit and Risk Committee when the deal closed shortly after the board meeting, he took some comfort in these additional safeguards. But he didn't only wait to receive formal reports: he also stayed in touch with the Chair and with co-investor Julie who had both remained on the board. So, he was aware that, as a growth strategy, GoHardy was considering the introduction of a new bundled product service. This service would install water harvesting equipment in customers' homes, not just deliver the supplies to the house as before. This clearly increased risk, but Ranjit also appreciated the potential environmental benefits of the solar push.

Ranjit also continued to hear from CFO, Meera, who still sought his advice from time to time. So, he wasn't surprised one day to receive a call from her six months after his last board meeting. He was surprised, however, by the tone of concern in her voice. She got to the point fast.



3

Audio 3 of 4

TRANSCRIPT

[Ranjit]

'Mmm, I hear you. Did you raise this concern with Atul?'

[Meera]

'Of course, I told him that as CFO, I couldn't just ignore a policy. He became quite agitated and said that maybe we needed to change the policy. He thought it should be good enough if a major shareholder vouches for a supplier or another party.'

[Ranjit]

'Do you know what type of due diligence BOB Construction actually does on its suppliers?'

[Meera]

'Not yet, I can ask – I don't expect much at all, but I am worried that Atul would get upset if he heard that I even asked. And I can imagine that Vijay would explode. Several of my Exco colleagues have already experienced his anger when they question something he has recommended.'

[Meera]

'Ranjit, I need your advice. Things are changing so fast here, and I have some concerns. All indications are that if we do a big launch, the demand for the solar water harvesting installation service will likely exceed what our existing suppliers can deliver. But Vjiay Rao, who is now taking an interest and actually attended the last board meeting, has proposed a solution. After meeting with him yesterday, Atul has asked me to expedite the process of taking on a new large supplier called BC Water Supplies onto our platform. He says that BOB Construction buys from them, and he himself vouches for them. Atul thinks that should be good enough for us, and we don't need to waste time on further vendor checks.'

Ranjit thought for a moment.



3

Audio 3 of 4

TRANSCRIPT

[Ranjit]

'I haven't heard of this company, BC Water. What is your concern about them, Meera?'

[Meera]

'Well, as CFO, I am generally concerned that expediting this would override our procurement policy: as you remember, seeing you nudged us to introduce the policy, we should undertake background checks of all large suppliers, including conflict of interest checks and review of their ESG and ABC policies. But frankly, I hear from some of my colleagues in the industry that BC Water has a bad track record – not only do they have problematic labour policies in their factories, but they also have a reputation for being generous with their support to politicians in the cities where they have manufacturing plants.'

[Ranjit]

'Thanks for letting me know, Meera. If he raises it again, why not remind Atul of the board's decision that shareholders would be consulted before changing any ESG policies and procedures – this may be framed as a procurement issue, but screening of suppliers is also addressed under these policies. Also, I suggest that you do the due diligence as quickly as you can. I'll ask around my network about them as well and let you know what I find. And if you find evidence of potential issues, but you come under more pressure to approve BC Water nonetheless. In that case, I suggest you refer the matter to Julie as the Audit and Risk Committee chair on the basis that this committee would need to review any material waivers or overrides of policy and discuss new risks arising from pivots in business model. They also should review new risks arising from material changes in the business model. In fact, I'll speak with her myself because I know she has a clear eye on the risks of complex new service lines.'

By the end of the call, Meera sounded somewhat relieved, but now Ranjit was concerned. This was exactly the type of thing he had feared might happen, where pressures to grow were compounded by external influence to cut corners. How could he help to address the situation?





3 Audio 3 of 4



Read the transcript on Page 80.


Question 1

The board’s decision to extend shareholder reporting rights is an example of:

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

Continue 



The board's decision to extend shareholder reporting rights is an example of Hard (legal) Rights. These are entrenched and enforceable by law.

It's about shareholder rights, and thus, it's not an example of Soft Power.

It is not ecosystem leverage, as this is inside the company.

Continue



Question 1

The board decision to extend shareholder reporting rights is an example of:

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

3

Audio 3 of 4



Read the transcript on Page 80.

Question 2

The decision to allow ongoing access to Audit and Risk Committee materials increases Ranjit's...

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

Continue





The appointment of Ranjit as an observer to the Audit Committee increases his Soft Power because he has access to information and committee members.

It does not increase his Hard (legal) Rights, as he has no additional decision-making power.

It does not increase his ecosystem leverage as this is internal to the company.

Continue



Question 2

The decision to allow ongoing access to Audit & Risk Committee materials increases Ranjit's...

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

3 Audio 3 of 4



Read the transcript on Page 80.

Question 3

When Meera calls him for advice, this is an example of:

Hard (legal) Rights.

Inappropriate friendship with the executive team.

Soft Power.

Ecosystem leverage.

Continue



When Meera calls him for advice, this is an example of Soft Power. She didn't have to do this, but she clearly trusted his advice.

There is no indication that this is an inappropriate relationship, but rather, it is a trusted professional one.

It is not an example of Hard (legal) Rights - she has no obligation to do so.

It is not an example of ecosystem leverage; this happens inside the company.

Continue



Question 3

When Meera calls him for advice, this is an example of:

Hard (legal) Rights.

Inappropriate friendship with the executive team.

Soft Power.

Ecosystem leverage.

3

Audio 3 of 4



Read the transcript on Page 80.

Question 4

The actions Ranjit recommends to Meera are all examples of:
(Select all appropriate)

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

Continue





Ranjit recommends to Meera various actions that are examples of Soft Power. He proposes alerting key board members and reinforcing good governance by following policy.

This is also an example of ecosystem leverage as he proposes to consult his network about the supplier.

None of what he suggests is binding; thus, there are no examples of Hard (legal) Rights.

Continue



Question 4

The actions Ranjit recommends to Meera are all examples of:
(Select all appropriate)

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

The following week

A week has passed since Ranjit's conversation with Meera, where he had undertaken to call Julie, Audit Committee chair, on the basis that the Audit Committee would need to review any material waivers or overrides of policy.

Read the transcript for the **final audio clip** and the four questions which follow. Take some time to consider your answer for each question before moving on to the next page and revealing the correct answer.

Continue



Ranjit was true to his word and got hold of Julie at her home in the UK. She remembered the board conversation well, at which he had raised concerns, as well as the board's decision to strengthen certain ESG policies, though this was not a requirement of her fund. Julie also understood the reputational damage that GoHardy could incur as a result of an investee being singled out in the press for association with poor practices, especially in the current climate.

She reassured Ranjit that she would allow no change to the ESG policies before consulting all shareholders. Together, they talked about which of the other investors should be alerted to the potential issue to ensure that they could mobilise support to counterbalance the views of BOB Investments if that proved necessary. But she sounded a note of caution: Atul and his co-founder carried the balance of voting power on the board and among shareholders; and they seemed convinced about the growth path.

[Julie]

'If it comes to a showdown over changing the policy, I will let Atul know that then we would expect BOB Investments to buy out any investor who strongly disagreed. If they want to exert that level of power to change what we have all agreed is appropriate, then they need at least to pay for it now and not drag us along. I don't think BOB Investments is ready to do that yet, but maybe next year. But I won't let this happen by stealth or by default on my watch.'

Julie also agreed to speak with Meera to reaffirm her position about not cutting corners. If Atul continued to place pressure on Meera, she would use her powers as Chair to call an Audit and Risk Committee meeting at which she would seek a formal explanation. Ranjit would then also be present and could also engage in the wider conversation about new risks.

Her matter-of-fact manner left Ranjit feeling somewhat reassured. As they ended the call, Julie paused as she recalled something.



[Julie]

'You know, I remember when we discussed GoHardy's governance roadmap, you proposed we have an independent board effectiveness review every two years. We all agreed to add that to the board charter. That's due again soon. Once we are through addressing this particular issue, I am going to remind the board Chair of that. If the review is done well, at least it may surface some of the misalignment on the board and maybe even help to reinforce the commitment we all made to good governance for GoHardy's lasting success. Can you recommend any firm in India which would do this sort of thing?'

[Ranjit]

'Yes indeed. At Northwaze, we have been paying increasing attention to this issue and have even commissioned a thought paper on the role of board effectiveness. I'll send you the link. With some other investors, we also have tried out some firms, so I can definitely provide you with some names. Thanks, Julie, for taking this matter seriously: you understand that I want to see the best for GoHardy after all our combined time and money, not to see it take the path towards risk and even scandal.'



4

Audio 4 of 4



Read the transcript on Page 92.

Question 1

When Julie speaks of convening the Audit and Risk Committee, this is an example of:

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

None of these apply.

Continue





When Julie speaks of convening the Audit and Risk Committee, this is an example of Hard (legal) Rights. The committee charter would give her the right to do this.

She has the right, as chair, to do this; thus, it is not an example of Soft Power.

It is not ecosystem leverage, as this is inside the company.

Continue



Question 1

When Julie speaks of convening the Audit and Risk Committee, this is an example of:

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

None of these apply.

4

Audio 4 of 4



Read the transcript on Page 92.

Question 2

When Ranjit says that his firm has already identified specialist providers of board evaluations, this is an example of:

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

None of these apply.

Continue



This is an example of Ecosystem leverage. He may exert external leverage by being prepared in advance and cultivating names of trusted providers.

It is not an example of Hard (legal) Rights - there is no right to require that they be used.

They are simply resources on the broader ecosystem to call on, thus not an example of Soft Power.

Continue



Question 2

When Ranjit says that his firm has already identified specialist providers of board evaluations, this is an example of:

Hard (legal) Rights.

Soft Power.

Ecosystem leverage.

None of these apply.

4

Audio 4 of 4



Read the transcript on Page 92.

Question 3

About the requirement that shareholders be consulted about changes in ESG strategy, which statement best fits?

It is ineffective because the board could ignore shareholder views.

It may be effective: it provides a way to slow down a process of rapid change and make it transparent.

It is definitely effective: which board would overlook shareholders' views?

None of these apply.

Continue



The statement that best fits this is: 'It may be effective: it provides a way to slow down a process of rapid change and make it transparent.' The requirement to consult does not block the change but may give time and basis to influence it.

One cannot say that it is ineffective – it may help since transparency of consultation at least makes any changes clear and known and subject to possible influence.

One cannot say that it is 'definitely effective'. Shareholders may differ, so some views may still be overridden.

Continue



Question 3

About the requirement that shareholders be consulted about changes in ESG strategy, which statement best fits?

It is ineffective because the board could ignore shareholder views.

It may be effective: it provides a way to slow down a process of rapid change and make it transparent.

It is definitely effective: which board would overlook shareholders' views?

None of these apply.

4

Audio 4 of 4



Read the transcript on Page 92.

Question 4

How might having a board effectiveness review help the situation at GoHardy?

It may surface underlying misalignment of views and interests among directors.

It keeps an emphasis on the main question of whether the board is playing its role.

It won't – it is just a report so won't change anything.

None of the above.

Continue





A board effectiveness review might help the situation at GoHardy as it may surface underlying misalignment of views and interests among directors – it should probe these areas.

It would also keep an emphasis on the main question of whether the board is playing its role – this is a central question of any review.

Perhaps it won't help or change anything, but the question was how it *might* help.

Continue



Question 4

How might having a board effectiveness review help the situation at GoHardy?

It may surface underlying misalignment of views and interests among directors.

It keeps an emphasis on the main question of whether the board is playing its role.

It won't—it is just a report so won't change anything.

None of the above.



Commentators: how would you have played this?



GIULIA

Partner at a VC Fund

Page 103



JASPER

Associate at a VC fund

Page 104





GIULIA

Partner at a VC Fund

I am quite impressed by how our friend Ranjit has upped his game since we last heard about him. I used to think he was rather feeble – not using the influence he had as a board member in the early days – but in this case, he really seems to have matured. In particular, I like the way he anticipated that the board was unlikely to vote down the BOB Investments deal in the circumstances. However, he uses the opportunity to extract some commitments which mitigate the risk. Also, he has clearly built some social capital with other board members (well, maybe not Atul!) and Meera, which is pretty important to give him ongoing access to informal information. He seems willing to use the resulting Soft Power quite effectively. Frankly, I'm relieved to hear that GoHardy has found an experienced independent chair at this stage when the stakes are high, which can help navigate through the issues. If the old chair had been around, this might have turned out very differently.

Still, I think Ranjit may have missed a trick here – he could have pressed for some more extended rights for minority investors, for example, the right to audit information, so that he could at least send in auditors to check if he believes that management is concealing or misrepresenting data in future. At this stage, GoHardy should also have a Code of Conduct that applies to directors. Ranjit could have pressed for that to be applied to Vijay if there was evidence he was exercising undue influence that was not in the company's best interests.

I also think Ranjit could have probed a bit more about why BOB was pushing so hard for BC Water to be onboarded quickly. Maybe there was more to it, which would trigger additional safeguards. For example, if BC Water is in any way connected to BOB Construction beyond being merely an arms' length supplier, then it could be a related party in ways which would require BOB to declare an interest and the board of GoHardy to approve.



Yeah, I agree with Giulia. Ranjit's doing a lot better now, so I'd give him an A on this one. He managed to build in some new safeguards and, most importantly, maintained the connections even after he lost his board seat. He seems to have his Soft Power game working pretty well to compensate for his weaker position, and I really like that he has also been thinking of wider plays to improve governance in his market. I find that can be a powerful way to build alignment among investors, although you sometimes come across the likes of BOB Investments, who don't seem to care much.

This brings me to this: Soft Power can really help, but if there is a showdown, it only gets you so far. Ranjit really should have negotiated those additional measures right up front, in Series A, when he was in a stronger position as lead investor. They really are basic ones that should be included in all shareholder agreements. Then, there wouldn't have been any need to negotiate them later when the company was hard-pressed for cash. He could then have focused on other issues. For example, he could have proposed setting up an ESG Subcommittee to the board and volunteered to stay on that, even when he had to step down from the main board.

I still think there may be a showdown coming at GoHardy, but at least Julie is calling BOB Investment's bluff early about acting like the controlling shareholder before it is and, by doing so, prejudicing the interests of other minority investors. If they do push it, maybe she can force them to buy out dissenting minority investors, including Northwaze, so that they are not dragged along a risky and unethical path.

**JASPER**

Associate at a VC fund



Key takeaways

- » VC Fund Managers need to actively **SHAPE their influence on the governance of investees over the investment life cycle, even as their equity stake dilutes and the investees' risks evolve.**
- » Starting at the pre-deal investment phase, a VC Fund Manager **should assess and then design a risk-based mix of Hard Rights and Soft Power strategies** to maintain influence over an investee's governance in anticipation of dilution. This means:
 - Negotiating for key Hard Rights on an enduring basis; the investment context will affect whether all the desired rights can be secured.
 - Implementing Soft Power strategies such as developing trusted relationships with the board and inside the company and forming coalitions with like-minded co-investors to help mitigate the risk of limited access to information and diminishing Hard Rights over time.
- » **Engaging the wider ecosystem** consisting of other investors, service providers and industry influencers can also build channels and identify resources through which to apply external influence on investees.
- » VC Fund Managers need to **allocate their time and financial resources** appropriately to shape influence strategies across their portfolio of investees to best manage their risk.

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