KARL SJOGREN

CATEGORY

BLOGGER / AUTHOR

Current Position:

Blogger & author-in-progress (*Fairshare Model*)

Karl's journey …

Consulting **CFO/Controller** [*Start-ups* & *Turnaround Situations*]

Education:

- **BA** – Business/Pre-law (*Michigan State University*)
- **MBA** – Finance (*Michigan State University*)

FAVORITES…

- ***Hobbies***
  Myriad forms of physical activity; museums and the arts, cooking and thinking about stuff.
- ***Favorite Cuisine/ Food***
  Fresh, zesty and varied
- ***Favorite Movies/Series***
  2001, A Space Odyssey and Six Feet Under
- ***Favorite Artist***
  Auguste Rodin
- ***Favorite** (economic) **Book***
  - *Mass Flourishing* by Edmund Phelps
  - *Capital Ideas* by Peter Bernstein
- ***Favorite Quote(s)***
  "What is government itself, but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."
  - James Madison, Federalist Paper No. 51

Karl M. Sjogren is a thought leader in the concept of performance-based capital structures. His expertise is rooted in his experience from 1997 to 2001 CEO of Fairshare, Inc. Nearly a decade before the term equity crowdfunding was coined, Fairshare was a frontrunner for the concept. His ideas are also informed by work as a consulting CFO for start-ups and companies in a turnaround situation. Karl is writing a book that advocates the use of a performance-based capital structure called the Fairshare Model when companies venture capital via a public offering. The Fairshare Model shall be extensively discussed in today's article.

Karl, thank you again for granting this interview to Storm of Beta.

How would you briefly describe what "The Fairshare Model" is?

The Fairshare Model is a performance-based capital structure for companies that raise venture capital via a public offering, one in which an average investor may invest. It is designed to balance and align the interests of investors and employees. My vision for the model is that it will enable average investors to make venture capital investments on terms comparable to those that professional investors get.

Where does the inspiration for the name of the model come from?

It is part legacy and part aspiration. Fairshare was the name of a company that I co-founded to promote a form of equity crowdfunding. It operated from 1997 to 2001, failing in the wake of the dot com and telecom busts. The name exemplified our goal at Fairshare, which was to popularize a deal structure for public investors that mirrors what venture capitalist get in a private deal. We had some success—16,000 members—but the economic climate deteriorated before we could offer more than education.

Fast forward fifteen years, the time is ripe for what Fairshare represented. Angel investors are more numerous and have become more organized. Business incubators pepper the landscape. Companies have executives who have "innovation" in their title.

Universities offer degrees in entrepreneurship, innovation and social networking. “Disruptive” has acquired a positive connotation. Far more people understand the significance of valuation. The JOBS Act is law. Lots of things have changed to make the Fairshare Model more captivating. And, there are more platforms available to help implement the concept. There is, however, a need for someone to push the concept into the arena of public debate—that’s the job of the book I’m working on.

From an aspirational perspective, the Fairshare Model promote fairness at the micro-economic level by offering a framework that provides entrepreneurs incentive to offer public investors a VC-like valuation. Also, because it facilitates stock compensation that better reflects how employees perform as opposed to how well they negotiate their compensation package.

At a macro-economic level, the Fairshare Model promotes fairness by providing a vehicle for those who rely on the return on labor to participate in the historically higher return on capital. This happens in two ways. Average investors can invest modest amounts in an IPO with a VC-like valuation. And employees can participate in the valuation rise that results from their labor.

So how does it actually work? What is the core concept behind the model, and at what stage of the process does it come into play?

To begin with, the Fairshare Model is for a public offering, one that regulators allow to be sold to any investor. Also, it is designed to raise venture capital, that is, capital for a company that has uncertain prospects and depends on new investors to fund operations. It is common for IPOs to be used to raise venture capital but it is uncommon to call it that. For example, biotech companies often go public before they are profitable, some even before they have a product. Clearly, such companies raise venture capital via a public offering.

With that preface, I’ll address your questions in reverse order. The stage of development can be at any point in a company’s development—startup, expansion, mature or decline. The driving factor relates to the issuer’s ability to attract investor interest, not its stage of development. If there are enough investors who want to invest, a company can have a public offering.

The core concept is to structure the IPO similar to a VC round—to offer price protection. Put another way, the Fairshare Model can minimize investor risk of overvaluation and can mitigate the risk of business failure by offering a powerful incentive for the entrepreneurial team to meet investor expectations.

How does it work? Structure wise, the Fairshare Model has two classes of stock. Both vote but only one can trade. I call the tradable stock “Investor Stock” and it is issued to pre-IPO and IPO investors. Employees get it too for the value that they have already delivered. I call the non-tradable stock “Performance Stock” and it is issued to employees for future performance. Based on performance milestones, Performance Stock converts to Investor Stock. As a class, the voting power of the Performance Stock is capped at 50 percent. The number of Performance Stock shares issued as of the IPO will be enough for years of conversions—perhaps up to ten years. However, Investor Stock will have at least 50 percent of voting power even when it represents less than half of the total shares issued.

Has the model ever been put into practice by a company?

No, it is just an idea at this point---one with a three stage implementation plan. The first stage is to demonstrate that there is a critical mass of with interest in the Fairshare Model. Generating that interest is the job of my forthcoming book.

In the second stage, experts in areas such as securities, tax, financial reporting, secondary markets, corporate governance and organizational behavior will evaluate how to make it work for their clients. This will only happen if it is clear that there is investor interest in the model. Entrepreneurs and their angel investors will be part of this de-bug phase too. Key questions will relate to Performance Stock—how to define and measure performance, and how to manage its conversion to Investor Stock. Some solutions will be shared by many adopters of the Fairshare Model. Some solutions will be distinctive based on industry, stage of development, culture and the personalities involved.
The third stage will begin when companies try it! How long might it take for the model to be used in an IPO? My guess is two to three years after the book is out, but it could happen faster.

Who are the main targets of the model? Could you quickly describe the main types of companies involved and their respective role?

Early adopters of the Fairshare Model will likely be companies that have raised a round or two of angel capital and seek an alternative to a VC. They will want to raise at least USD $3 million, given the cost involved in a public offering, but there is no upward limit on how much might be raised.

The table below summarizes target companies for the model. A chapter profiles them and considers scenarios for Performance Stock conversions for two types of companies that are strategic for the Fairshare Model to gain acceptance, a Feeder and an Aspirant.

Category of Company	**Strategic for Fairshare Model?**	**Goal**	**Likely Offering Size (USD $)**	**Likely to be a SEC Reporting Company?**	**Expectation of Performance Stock Conversion**	**Secondary Trading Market**
Feeder:	Yes	Launch then get acquired.	$3M to $7M	Maybe	High	Pink Sheets; principal investor exit via acquisition
Aspirant	Yes	Build a company that lasts	$5M to $20M+	Yes	High	Pink Sheets, regional exchange, or NASDAQ Micro
Pop-Up	No	Offer equity in a project	Less than $5M	Unlikely	Low	Same as Feeder
Spin-Out	No	Alternative to new VC round	$5M to $20M+	Yes	High	Same as Aspirant
Rejuvenator	No	Fund turnaround	$20M+	Yes	High	NASDAQ Micro or better

I'll describe a Feeder.
The name is inspired by "feeder fish," the kind pet stores sell as food for large fish. Similarly, a Feeder aspires to be acquired after it builds its product and demonstrates it's potential value. When the acquisition offer comes, both classes of stock have to agree on how much Performance Stock converts. If they don't, there is no deal. Thus, an entrepreneurial team is positioned to earn a greater share of the acquisition price than they would get if VCs provided the IPO money.

To learn more, check out chapter five, Target Companies for the Fairshare Model.

What about the typical investors? Due to the risks that may incur, is retail also suitable, or should there be investing "hurdles" (i.e. at least *Accredited Investors*)**?**

The Fairshare Model is designed for a public offering, one that anyone may invest in. That said, an issuer might decide to sell all of its new stock to accredited investors. They, in turn, could sell off some of their shares in the secondary market. At the opposite extreme, an issuer might focus on unaccredited investors. The larger the offering, the more likely it is that an issuer will try to place a large amount with accredited investors. That will encourage small investors to sign up and shorten the time it takes to close the offering.

What is the rationale behind creating a website (www.fairsharemodel.com) to "crowd vet" ideas?

Presenting my ideas openly invites critical feedback, which helps me make the final product better. It also seeds the market for the book. Once the Fairshare Model is in someone's head, its hard to forget. But it takes time to drink in fully. I'm hopeful that the people who get the pre-publication exposure will evangelize the concept and create demand for the book, once it is available in 2016.

Turning to the book's structure, what are the main aspects addressed?

I have five sections so far. The overview section covers the Fairshare Model, a conventional capital structure, crowdfunding, target companies for the Fairshare Model and its history. The second section considers the context for the model like economic growth and income inequality. It also includes a chapter called the Tao of the Fairshare Model, which contrasts how uncertainty is addressed by a conventional model and the Fairshare Model. If you have time for just one chapter, read that one.

The third section deals with valuation—concepts, calculation, evaluation and disclosure. The forth section discusses the causes of investor loss—fraud, overvaluation and failure—as well as other objections to average investor involvement in venture capital. The final one is being written—among the topics are game theory, behavioral finance, secondary market trading and some technical issues.

In your opinion, what is the most remarkable aspect of the Fairshare Model?

It is that it provides venture-stage companies a reason to offer public investors a low valuation. Why? If an increase in the price of Investor Stock is a form of performance, Performance Stock shareholders have incentive to make the IPO price low, really low. This dynamic allows an issuer's insiders to say, in effect, we don't do well unless you do well.

You also refer to a "secret sauce" which has to do with Human Capital. What are you referring to?

This excites me most! A Fairshare Model issuer will be positioned to outcompete larger, better financed companies for the employees it needs. They can say, for example, we raised our capital and can pay you a salary…but not as much as Google. We can give you benefits…but not as much as Google. We can grant you options on our Investor Stock, which has more upside than Google's. And, we can offer you something that Google can't, an interest in our Performance Stock pool. It is priced like founder's stock and only has value if we, as a team, deliver the performance that results in conversions to Investor Stock.

My bet is that the best workers will be attracted to such a deal and that Performance Stock will play an important role in making a Fairshare Model issuer more valuable. This potential to align the interest of capital and labor is powerful and as it proves itself with small companies, large companies will pay attention.

I pose a thought experiment when describing the types of companies that might use the Fairshare Model. How differently might General Motors have responded to the challenges it began to face in the 1970s—low mileage products, uncompetitive costs and quality—had it used the Fairshare Model? I suggest that the quality of communications, the sense of urgency, responsibility and commitment at all levels of GM would have been better and that its unionized workforce would have approached negotiations in a more collaborative manner.

The potential to balance and align the interests of capital and labor is a big deal that affects companies at all stages of development. If the Fairshare Model can do this, its appeal will not be limited to young companies that seek to attract investors; it could lead to a re-imagining of capitalism.

What do you consider to be the main issue with conventional capital structures? What is the "fix" you propose, and what would be the related benefits for companies & investors?

The core problem is that a conventional capital structure requires a value for future performance whenever new stock is sold. That is very hard to do in a reliable manner.

To illustrate, let's say that I form a company and sell half of it to you for USD $100. Implicitly, we've agreed that my idea is worth $100. The company is worth your $100 plus my idea, or $200 in total. The problem is, neither of us know if my idea really will be worth $100. Add zeros behind it and you can see how the problem grows as the amount of money raised climbs.

The Fairshare Model's fix is to eliminate the need to set a value on future performance. Instead, the parties agree on how to reward the performance that is delivered via Performance Stock conversions. Put simply, the Fairshare Model rewards achievement whereas a conventional model rewards promise.

The benefit for companies is that they can compete for capital by offering IPO investors low risk of over valuation. That will attract investor interest. The deal is, that investors will get diluted, possibly a lot, as the company performs.
However, if that performance has economic value, the value of the investor's stake should go up. VCs say they would rather have a smaller piece of a big pie than a big slice of a little one. Same idea.

For new investors, there are several benefits. They minimize the risk of paying too much for their position; overvaluation is ordinarily a huge risk. The team they invest in is highly motivated to deliver results. Their company is well positioned to attract the best talent. Finally, the Fairshare Model facilitates diversification within an investor's venture portfolio. For example, say that an investor is willing to invest USD $5,000 a year in venture stage companies. If it goes into conventional deals, one or two stocks can consume it all. But if all the money goes to ventures that use the Fairshare Model, that investment could buy the same percentage of ownership in five to ten times as many companies. Why? Because IPO valuation is so much lower because the issuer is not putting a value on its future performance.

The chapter called The Tao of the Fairshare Model discusses why angel investors will like the Fairshare Model.

You said in another recent interview that "*Fairshare Model is bringing the IPO investor to the dance and it doesn't forget them",* **why is that?**

It's a matter of respect. The model provides companies incentive to provide their IPO investors with a VC-like deal, that is, to treat public venture capital with the respect given private venture capital. The chief way is by offering a valuation that is on par with what a VC would get.

It is not difficult to find IPOs where the valuation was revealed to be too high for new investors. This is the Achilles' heel of a conventional model—one must price the value of future performance, something that is hard to do. Fair-minded people can set it too high; opportunistic and overly optimistic ones certainly will. Using game theory, one would say that a conventional model is infused with a win-lose proposition when it comes to setting valuation.

Capitalism-as-we-know-it in the capital markets relies upon the eagerness of *hoi polloi* investors in the secondary market to drive the price up. This is incentive for the broker-dealer's clients to buy the IPO shares. One could thus say that a conventional model rewards IPO investors, but that reward is often reserved for a broker-dealer's best customers, not average investors.

Another problem is that this approach does not scale down to the early stage companies that struggle to get investors. It works for large, easily-hyped companies but not small, obscure ones. Now, all IPO investors incur a risk of overpayment but it is far higher with a conventional model versus the Fairshare Model.

Furthermore, a conventional model encourages issuers to view IPO investors cynically, as a source of money, not as a venture partner.

That's because IPO investors buy in at the highest valuation. The voting power attached to the new shares is relatively low, which further encourages companies to slight them after "the dance"and favor the interests of insiders.

A variant of this accountability dynamic exists in the private capital market. The chapter that describes objections to public venture capital includes a Harvard Business Review article called *Six Myths about Venture Capitalists* by Diane Mulcany. She directs the Kauffman Foundation's investments in VC funds and her article states why such investors should be unhappy.

In a version of the piece that appeared in the Huffington Post, she wrote:
What we [the Kauffman Foundation] found is that VCs are good capitalists. They sell what their investors will buy, and they charge what their investors will pay. The real problem, it turns out, lies with the institutional investors -- the ones doing the buying and the paying -- and their investment committees, who are charged with the fiduciary responsibility to oversee and approve venture capital investments.[1]

One of Mulcany's complaints is that VCs spend too much attention to how to enhance their own compensation and not enough on how to improve the returns of their investors.

In contrast, The Fairshare Model creates incentive for all investors in a company to be good partners with the entrepreneurial team; there is incentive to collaborate on setting and adjusting performance criteria.

What would you say the principal implications of the model are? For instance, how does the valuation process and the definition/measurement of performance differs with respect to the Traditional case?

Everyone will agree that a traditional or conventional capital structure requires that a value be placed on future performance when a company sells new stock. They will also agree that this is very hard to do. Some will suggest they have an especially insightful way to do it.

My approach is to change the rules of the game. In the Fairshare Model, valuation unfolds through performance. It is not a bet that must be placed long before the performance is delivered.

It is novel to propose a performance-based capital structure for a public offering but it is standard practice for VCs. Their deal terms provide price protection in the form of liquidation preferences, redemption rights, dividends, etc. So, I didn't reinvent "the wheel" of price protection, I put it on a different vehicle—a public offering.

This brings an ethical question into focus—who should bear the uncertainty of future performance? Should it be principally borne by the company's insiders, its employees and pre-IPO investors, or by new investors? If you think new investors should have most of the risk, you'll support the conventional model. If you think it should be shared more evenly, you will like the Fairshare Model.

My answer to your question boils down to this—the Fairshare Model is an attempt to offer public venture investors a private venture capital deal and offer entrepreneurial teams more of the wealth that they create than they would get in a VC deal.

Interestingly, the Fairshare Model supports diversity in how performance is defined—it can be whatever shareholders agree it should be. And this, in turn, widens the potential for companies with non-traditional goals, like those focused on social good, to attract capital.

[1] Diane Mulcany, "The Three Myths of Venture Capital", Huffington Post, July 23, 2012. http://www.huffingtonpost.com/diane-mulcahy/venture-capital-myths_b_1533451.html

What would you say is the Good, the Bad, and the Ugly side of your experience with the Fairshare company, including when it collided with state securities enforcement in California back in the days?

The context for the question is explained in the chapter called My Path to the Fairshare Model. A brief recap is that in 1998, Fairshare launched an effort to build an online community of people who shared interest in investing in the public offerings of young companies that used the Fairshare Model. We offered free and paid memberships. Once we had enough members to be a potentially credible source of funding, we said we would invite companies with a legal direct public offering to pitch our members for free. The conditions were that they had to pass a due diligence review by our members, use the Fairshare Model and allow members to invest as little as USD $100.

The good was that securities regulators outside of California gave us an opportunity to figure out how to address their concerns about our plan to facilitate offerings without being a broker-dealer.

The bad was the discovery that the regulatory scheme makes it hard to be innovative in the marketing of securities. On the one hand, securities law allows an issuer to sell its offering without using a broker-dealer. On the other hand, regulators make it difficult for anyone to facilitate the process unless they are a broker-dealer. As a result, direct public offerings occupy a twilight zone—they are legal but shackled when it comes to marketing.

The ugly was a diminishment in my confidence in government. The California regulator's response to Fairshare's membership was premature, severe and relied on novel reasoning. We had said our plan would take more than a year to develop, faced an array of obstacles and might not work. Still, with no engagement, California banned memberships from being offered in that state because it said that a membership, even a free one, was itself a security, an investment contract. That position, by the way, was rejected out of hand by other regulators.

Taken altogether, I learned how difficult it is to reconcile efforts to lower the cost of capital with concerns about protecting investors from possible fraud. The chapters that explore the causes of investor loss in venture-stage companies suggest that over valuation and honest failure cause far more investor loss than fraud, however.

What do you aim to accomplish with your advocacy for a SEC requirement to disclose valuation?

Ah! You refer to the chapter called Valuation Disclosure, which makes my case for the U.S. Securities and Exchange Commision (and by extension, all regulators) to require that all issuers be required to disclose the valuation they give themselves in their offering. I have three goals.

First, to make it easier for investors to evaluate one of the most crucial attributes of a stock investment –the valuation. At present, they have to calculate it themselves and many are unsure how to do it or may not bother to.
Second, to make it easier for third parties to aggregate data on valuations. It would be helpful to know an issuer's valuation trend over time and how it compares to comparable companies.
Third, the more investors know about valuation, the more likely it is that they will attracted to offerings that use the Fairshare Model!

What were the biggest and most common problem faced by the Start-ups/Turnarounds that you were consulting as a CFO in your earlier years? What is the main lesson you have learnt from those times?

I've come to appreciate the companies that make it. There are many ways to fail and relatively few ways to succeed. I learned that undercapitalization is a profound and common problem—it can be very hard and time consuming to raise the capital needed. It is easier to build or repair a company when you have the capital to do it.

I learned a lot about failure too. There is a chapter that explores research on this subject whichindicates that loss of market is the leading cause, followed by management failure.

What is the one thing you wished you had known before initiating your career?

I wish I had been more astute at assessing risk and recognize when to change course.

If there is one piece of advice you would give to a fledging entrepreneur, what would it be?

Place yourself where things can happen. Recognize that you are there. Be forward-looking and disciplined as you develop the opportunity. If you don't find purpose in the endeavor, don't be an entrepreneur!

What is the long term, optimistic, view on the Fairshare Model? Could we say that it has the potential to become a new, more efficient type of "equity crowdfunding" platform?

In a generation, I expect that the Fairshare Model will be a mainstream option for raising venture capital.

Best practices will emerge to address the challenges of Performance Stock. How to define and measure performance and how to allocate the benefits of it are human behavior challenges that can best be met by small groups of people who want to affiliate. That is, people who choose to invest in a company or work there are more likely to collaborate effectively than large numbers of people in the general population.

There will be variations of the Fairshare Model based on industry, stage of development, geography and the personalities involved. What works for an expanding Italian manufacturer will differ from a UK software start-up, for example. Similarly, a San Francisco food company and Texas biotech firm will adopt a different form of the model.

Whatever the business, wherever it is located and whoever is involved, they will share a common ethos about how to treat their IPO investors. They will feel that the uncertainty of future performance should be shared fairly between insiders and IPO investors. Performance Stock presents a way to reward insiders for actual performance. How it is distributed will vary by company.

If you could have a coffee with 3 different people dead or alive, who would it be?

Either Charles Darwin or Henry Russel Wallace, the co-creators of the theory of evolution.

Joseph Campbell, who studied comparative mythology and religion.
James Madison, the principal framer of the U.S. constitution and fourth American president.

You are an author, blogger, experienced CFO … what's next for you?

I have about 95 percent of an initial draft of the book uploaded. I'm turning more attention to how to get it published. At this point, I may crowdfund for the funds needed to hire editors, illustrators and others that can get the book into print and e-book by Q1 of 2016. If Storm of Beta readers have suggestions, I'd like to hear about them!

Thank you Karl for your very insightful comments Karl, the Storm of Beta team hopes to have you again very soon.

FURTHER READINGS

- **Website:** www.fairsharemodel.com (draft chapters are under the Resources tab)
- **Slide deck presentation of the Model**: http://www.slideshare.net/kmsjogren/fairshare-model-fintech-presentation-052815-53181114
- **An abstract describing the model:** https://www.linkedin.com/pulse/fairshare-model-karl-sjogren?trk=pulse_spock-articles
- *Related publications*: **A Call to the SEC to Require Valuation Disclosure** [VC Experts; May 2013] https://vcexperts.com/buzz_articles/1354