Innovation and the Creation of Venture Capital Organizations

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Just after World War II, venture capital organizations arose and developed distinctive practices to evaluate, monitor, and support innovative ventures. An important part of their approach was developing distinctive networks of information about people, technology, and markets. Venture capital organizations not only reduced the risk of venture investing; they also became a countervailing power supporting independent venturing in an economy dominated by large, established corporations. This paper presents a functional and rhetorical analysis of the innovation of creating distinct venture capital organizations in the United States.

Most of the pioneering venture capital firms organized in 1946, but earlier threats and opportunities in the investment environment were preconditions for the innovation. Two major changes began as early as the 1920s: the decline of informal venture investing and the decline of venture capital-like functions in institutional finance. Two shifts in the 1930s--an increase in internal corporate financing of innovative ventures and the reemergence of government financing for industry--indicated to financiers that their role had declined. Government contracting during World War II showed that innovative industrial ventures previously considered too risky to finance could succeed.

The innovation of creating venture capital organizations also was ideologically motivated. Financiers began talking of "venture capital" in 1939, as they moved from the crisis of the Depression into the crisis of World War II. They perceived that the past decade's social and economic turmoil would worsen and jeopardize private capitalism in the United States. Financiers linked the decline of investment in new enterprise to their own decline. Naming the venture capital problem focused attention on solving it.[1]

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[1]The core of my research [40] was in the federal and state cases in the Lexis and Westlaw databases, the proceedings of the Investment Bankers Association conventions, the *Harvard Business Review*, and the *Public Affairs Information Service*. The databases contain Supreme Court cases reported since 1790, other federal cases reported since 1912, cases of the highest state courts reported since the 1880s, and some lower state court cases reported before World War II. The IBAA conventions date back to 1912. The *Harvard Business Review* began publication in 1922. The *Public Affairs Information Service* first appeared in 1915.

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"No one in the high income tax brackets is going to provide the venture capital and take the risk which new enterprises and expansion require, and thereby help create new jobs, if heavy taxes take most of the profit when the transaction is successful," Jean Witter, of the San Francisco investment banking firm Dean Witter & Co., stated in his presidential address to the 1939 Investment Bankers Association of America convention [68, p. 6]. For Witter, venture capital was not a specialized area of finance but a traditional component of some wealthy individuals' portfolios--investment in "businesses in the experimental stages." Yet he described functions that specialized venture capital firms organized after World War II would develop further: cultivating specialized knowledge to assess specialized risks, working closely with ventures, and troubleshooting [68, p. 11].

As early as the 1920s, wealthy individuals' traditional role as informal venture investors declined; their funds shifted to the stock market and to trusts administered by banks. After the 1929 stock market crash, individuals--wealthy or not--categorically shunned risky investment and delegated more investment decisions to institutions. Venture investing became less attractive to wealthy individuals during the 1930s as tax rates grew heavier and more progressive and as tax law interpretations discouraged venture investing [6, pp. 139-40; 25, pp. 344-59; 34; 35, p. 162; 38, p. 31; 48; 53; p. 63, p. 240; 64, p. 23]. Much capital moved from decision makers who had done venture investing but now were leery of it to decision makers bound by law and tradition.

Investment banking practices that could have encouraged new ventures declined during the 1920s and 1930s. State securities commissioners rejected innovative industrial ventures during the 1920s, but investment bankers shared their disapproval [65, pp. 296-97]. Investors' risk aversion after the 1929 crash prompted and sustained federal securities regulation. Investment bankers readily abandoned practices suitable for financing ventures.

Although there were important exceptions, fraud and practices that fueled speculation were associated primarily with the newer investment banking firms [4, pp. 240-55, 270, 299, 320]. Established investment banks that survived wanted to distance themselves categorically from the aggressive, venturesome practices of the 1920s. New enterprise became a scapegoat [29, p. 109]. A 1933 IBA resolution called for changes in the law to let "responsible," "established" enterprises get capital [13, p. 12].

The Glass-Steagall Act and competitive bidding requirements in underwriting may have hurt innovative ventures' chances of obtaining financing [4, pp. 370-75, 432-56]. At the 1936 IBA convention, Francis Frothingham of Coffin & Burr (Boston) predicted that investment bankers' relationships with their clients would deteriorate: "If securities were offered for public bidding . . . the company ceases to have friends--only acquaintances, ready to bet to their own advantage, who feel no sense of responsibility to the company and correspondingly give but meagre service to investors" [19, p. 102]. The prospect of applying knowledge gained in the risky, labor-intensive process of handling a company's early financing to its later financing might have encouraged investment bankers to finance ventures.

As funds and decision-making power shifted from individuals to institutional investors, the institutions faced new constraints. Long before the

1929 crash, fiduciaries in states other than Massachusetts could invest only in securities on approved lists [30, p. 12]. Following the crash, many states further restricted institutional investment [9, p. 47]. Institutional managers' own increased risk aversion added to the constraints of law and tradition.

Established corporations placed more securities directly and relied less on investment banks because the Securities Act of 1933 did not require issuers to register transactions "not involving any public offering" [4, pp. 393-94; 27, pp. 198-99]. Investment bankers began to look more favorably at smaller businesses during the 1934-37 recovery. "It is to them [smaller companies] rather than to our large industrial corporations, well fortified with cash even after the depression, that we must look for the initial moves in raising capital from outside sources," [62, p. 49]. These comments reflected IBA members' concern that large corporations' increasing reliance on private placements would bring a further decline in the investment banking business [61, p. 225].

Corporations' strategy of internalizing and institutionalizing industrial research, which had begun at the turn of the century and spread during World War I, expanded during the Depression. Faced with excess capacity, corporations had new incentives to diversify by commercializing their research departments' discoveries [5, pp. 372-78]. Federal securities regulation also encouraged internal venture financing. Many corporations chose not to finance new ventures with public securities offerings because they did not want to disclose information that the 1933 and 1934 Securities Acts required [27, p. 199].

However, analysts in the mid to late 1930s believed that Depression-era tax increases jeopardized internal venture financing. At the 1936 IBA convention, Karl Compton, president of MIT, suggested that the new undistributed profits surtax illustrated how "governmental regulation has been directed almost entirely at the curbing of exploitation and has generally ignored and sometimes even penalized attempts toward technical progress." Although the new tax might encourage corporations to spend more on research to increase business expense tax deductions, federal officials were questioning AT&T's right to expense research that would have future rather than current-year benefits for customers [7, p. 232].

Contemporary analysts believed that independent ventures were at a relative disadvantage in financing innovations [22, p. 193; 33, p. 220]. Alfred Buehler observed in 1939 that the excess profits tax, revived in 1933, "penalizes young and growing corporations and other risky ventures where the rates of return are highly variable, since it hits them in their peak years" [3, p. 148]. Inventors and innovators had little bargaining power with established corporations during the Depression [17, p. 76; 26, pp. 288-89]. As technological innovation became more dependent on scientific research and established corporations internalized research, independent technology ventures were at a disadvantage. The rise of specialized venture investing after World War II helped create an infrastructure to support independent venturing.

Government venture investing reemerged during the New Deal, but New Deal programs to finance private industry did not take on venture capital functions. Financing the innovative industrial projects of the Tennessee Valley

Authority was venture investing. In contrast, although the Reconstruction Finance Corporation made loans to small businesses, it was not organized to finance ventures. "[T]he extension of credit differs fundamentally from the provision of 'venture capital' which is forthcoming under the inducement of possibly high but uncertain returns," John Glover observed in 1939. RFC borrowers could not be in the "developmental or promotional stage" or use RFC loans to finance invention or buy patents [20, pp. 466, 472-73]. Distinct small business financing programs were proposed during the Depression, but none were implemented [58, p. 25].

Still, the government's expanded role in finance and industry led some private investors to venture investing. In 1937, Leo Grebler observed that with the rise of government financing, tighter securities regulation, and institutional investment, "capital which is seeking more risky but more remunerative investments is transformed from the organized to the unorganized capital market" [22, p. 194]. "New uses for capital, new inventions, and new methods of production, may be the only surviving outlet for private savings, except increased consumption," Simon Leland predicted in 1938 [28, p. 260].

More importantly, the revival of active government development financing antagonized financiers, and they started to create a venture capital ideology. The small business financing program proposed in the second Mead Bill, introduced in November 1939, aroused special ire. It called for the federal government to share in equity financing. William Stoddard considered the bill "a sign, a portent, and a challenge to privately controlled capital: unless it does the job, socially controlled capital will do the job" [54, p. 265]. Stoddard urged financiers to preempt this trend by devising their own ways to finance small business.

Investment bankers recognized that two traditional links were broken--that between wealthy individuals and new ventures and their own link to established corporations. They realized that investment in new ventures was a distinct and important part of the financial system and that investment bankers might develop business financing ventures [62, p. 49].

Threats to accumulated wealth in New Deal tax policies stimulated thinking about the legitimacy of wealth. The venture capital concept suggested a new legitimacy for less regulated securities transactions outside the public markets as well as for wealthy individuals who would take an active role in venture financing. "The public should be protected from the harm that might arise from purchasing securities of any business in the experimental stages," Witter stressed at the 1939 IBA convention. "That early financing must be done by individuals close to the management of the new undertaking who are conversant with its risks" [68, p. 11].

By 1938 IBA leaders linked their concern that private capitalism in the U.S. was vulnerable to problems in new and small business financing. "The problems of small business are of the greatest importance to the whole scheme of things in this country," observed Frothingham [18, p. 46]. "If investors throughout the land, large or small, refrain from purchasing the unseasoned securities of a young industry and refuse to take a business man's risk, where will new industries obtain needed capital, and would not such a

development slow down the economic progress of the country," asked Marcus Nadler, a finance professor, at the 1938 IBA convention [35, p. 162].

By 1939 members of the financial community anticipated that the U.S. would become involved in the war abroad. "The future of the investment banking profession is at a new crossroads," Lionel Edie, an economist who ate lunch with future venture capitalist Laurance Rockefeller, warned at the 1939 IBA convention [24, p. 390]. Edie urged investment bankers to remedy "the deficiencies of our capital equipment." "You are going to be blamed for the situation which will be brought to light as we discover our shortcomings from the standpoint of national defense requirements," he said [12, p. 42].

Witter and other IBA leaders linked the IBA's goal of "reopening the capital markets" with public goals at the 1939 IBA convention: "The stimulating effects of revival in established industries should open the way for soundly conceived new enterprises and the development of infant industries, a promising source of more jobs for workers." To help small business, the IBA wanted to remove restraints on established investment practices rather than "put the government in the investment banking business." The size of securities issues exempt from registering with the SEC should be raised from $100,000 to $1 million. To help new enterprise, the association advocated "drastic" changes in the capital gains tax [68, pp. 5-6, 11].

Each aspect of the IBA's proposal addressed a basic policy issue that would influence the venture capital industry's evolution: the SEC's jurisdiction over small offerings, public supervision of fiduciary responsibility, and the share of the tax burden placed on capital gains.

In 1940 Stoddard noted that small business financing proposals that might forestall the rise of "socially controlled capital" already were emerging. The most promising, he thought, were for "industrial pools or financing companies." These "logical extensions" of wealthy individuals' traditional venture investing within local communities would provide management advice; they would do equity as well as debt financing [54, p. 274]. Stoddard envisioned the evolution of specialized venture capital organizations.

World War II was a watershed in the course of U.S. venture investing. Public policy helped bring structural changes that generated optimistic but often disturbing expectations of the postwar environment. The crisis atmosphere of war and fear of a postwar depression stimulated planning for a venture financing revival along with postwar "reconversion." In response to the legitimacy crisis of private capitalism, financiers aligned with small business and small investors to promote a broad vision of venture capital. Many opportunities for a new, more formal version of venture investing emerged.

Government and industry, often working together, accelerated and redirected technological innovation. The evolving arrangements for industrial research favored specialized venture investing. In 1941 Harvard economist Sumner Slichter noted that "[e]ffective arrangements for bringing industrial research within the reach of small enterprises remain to be made" [50 p. 88]. These arrangements developed during the war. Government, industry, and universities formed a research network based on the contract research that replaced much government laboratory research [32, pp. 188, 203]. Businesses

cooperated on patent use in piecemeal fashion, often voluntarily [37, pp. 298-301; 39, p. 310]. Subcontracting programs for federal procurement encouraged technology transfer to small firms; in unusual cases, technology was transferred to new entrants who worked alongside established corporations as prime contractors [46, pp. 11, 13; 47, pp. 88-91]. As purely internalized research became relatively less important, independent ventures could make more important technological contributions. Venture investors who could create information networks related to technological innovation would foster independent technology ventures.

Movement of people and resources for war production favored new venture formation and venture investing after the war. Decentralization was important for increasing military security, easing shipping, and using pockets of unemployed and underemployed workers. At the 1945 IBA convention, Director of War Mobilization and Reconversion John Snyder, a banker, suggested that financiers had not done enough to move capital to new industrial areas [51, p. 114].

The federal government encouraged spectacular industrial ventures by absorbing the risk of war production. Economist John Glover observed in the Reconstruction Finance Corporation's financing of war projects, such as developing synthetic rubber production almost from scratch, "tacit recognition of the economic 'unsoundness' of the projects and the inapplicability of the criteria of 'sound finance'" [20, pp. 202-09; 21]. The subcontracting system let prime contractors shift risk to subcontractors--many of which were new organizations. Because of the risk shifting, subcontractors who prevailed were more conditioned for postwar risk taking than were prime contractors. Seeing the extraordinary results of wartime ventures prepared many individual investors and institutional fund managers to take greater risks in postwar investing. The government's risk capital role also fueled a wartime debate about the decline of private capitalism.

Increased government financing indirectly helped liberalize institutional investment guidelines. As the United States geared up for war production, Albert Gordon of Kidder, Peabody & Co. reported that some states were responding to the excess private investment supply by giving institutional investors more discretion. Legislatures in some states and judges in others replaced rigid guidelines with the "prudent man rule"; this trend continued after the war. Bank trust officers and fiduciaries in insurance companies and pension funds gained much discretion, including authority to invest in common stock [30, pp. 11-39; 45]. To reduce risk as they bought more privately placed securities, institutional investors developed a more closely engaged approach to investment--active evaluation, direct negotiation, and flexible use of covenants [8, pp. 90-91, 105, 108]. In moving into the equity markets, institutional investors created a market for the growth stock that venture investors would nurture.

A broad vision of venture capital entered the public policy arena as public and private groups planned conversion to a peacetime economy. Investment bankers interacted with other groups lobbying for their own venture capital interests. They aligned fairly closely with small business and small investors against government and institutional investors, more loosely

with labor around the need to create jobs. Promoting venture capital to create jobs was a key goal of many tax reform proposals. A broad-based movement to expand the public equity markets overwhelmed the scattered interest in promoting, and possibly adapting, traditional venture investing.

Many in the financial community were attuned to the attractive postwar opportunities for riskier ventures. The Revenue Act of 1942 extended the preferential taxation of capital gains, which had applied only to individuals, to corporations. This reduced the disincentive to specialized venture investing through organizations; it also encouraged mutual funds to invest in the growing companies that venture investors prepared for public offerings after the war. However, the IBA's efforts to liberalize securities law and make public market financing more available to smaller companies failed. Because the broad-based politics of venture capital did not solve the problems of financing innovative new ventures, there were stronger incentives to create a distinct venture capital institution.

Gradual shifts in the investment environment would not have produced such a decisive innovation as the creation of distinctive venture capital organizations after World War II. Many of the pioneering organizations formed in the first half of 1946, while commercial and investment banks and institutional investors remained inert in financing innovative new ventures. Investors concerned only with exploiting postwar venture opportunities would not have emphasized that they were creating a new kind of organization.

The founders of J. H. Whitney & Co., Rockefeller Brothers Co., and T. Mellon & Sons shared several stated goals: achieving high returns with a high-risk investment and reducing a heavy tax burden with a capital gains strategy, creating a more effective way to finance innovative ventures, and benefitting society. They stated social goals with a sense of noblesse oblige and an acknowledgement that they must prove that free enterprise--and its accumulated wealth--met society's needs. In contrast to family holding companies that had formed earlier as a "negative defense" against heavy taxation, the new organizations were for active investment in growing ventures with social as well as economic merit [11, pp. 21-22; 59, p. 84].

A group of New England businessmen, scientists, and university administrators organized a revolutionary registered investment company in Boston in June 1946. American Research & Development Corp.'s founders wanted to create a model of the venture investing that they believed had become necessary--investing through organizations that would raise pools from institutions and individuals and use specialized knowledge to manage it. AR&D's founders highlighted its board of technical advisers with prestigious university posts and experience with industry or government. Brigadier General Georges Doriot, professor of industrial management at Harvard Business School, headed the advisory board and later became president. Doriot, as director of military planning for the Army's Quartermaster General and then deputy director of research and development for the War Department, had helped plan U.S. industrial mobilization for World War II [1, pp. 62-64; 10, p. 74; 23, p. 449; 49]. AR&D's founders challenged the conservatism of institutional investors. "There are in particular two large-scale repositories of wealth [life insurance companies and investment trusts] which

have a stake in the Nation's future and who should be concerned with a healthy basis for the prosperity of these postwar years," wrote a founder, Ralph Flanders, in a mission statement while AR&D was organizing [2, p. 125; 23, p. 447; 52]. Flanders had devised the Committee for Economic Development's postwar tax reform proposal (cutting taxes to expand venture capital to create jobs) [1, 2, 14-16, 23, 52, 60].

During World War II, the American West changed from being almost an economic colony of the East into a region with a rapidly growing diversified economy. The development of service and advanced technology industries, particularly aerospace and electronics, shot far ahead of their development in the East [36, pp. 3-34]. Frederick Terman, an engineering professor who returned to Stanford as the engineering school's dean after managing Harvard's Radio Research Laboratory during the war, urged California companies in science-based industries to push ahead of their Eastern counterparts [31, 55]. In this environment, West Coast financiers expressed little anxiety about postwar reconversion to a peacetime economy or proving the legitimacy of private capital.

Initially, there were signs that venture investing might organize on the West Coast as it did in the East. The link of the venture capital innovation with war financing and reconversion was close in the case of Industrial Capital Corp. and Pacific Coast Enterprises, two California venture capital organizations formed in 1946 [66, p. 43] A founder of each California organization had arranged financing for new military supply ventures while serving as a liaison officer with a Federal Reserve bank. A founder of each had been involved with the Surplus Property Board, which oversaw the transfer of government military production facilities to private industry [41-44, 56,57]. Founders of Industrial Capital Corp. and Pacific Coast Enterprises and a younger generation of pioneering West Coast venture capitalists initially did less to differentiate venture capital from conventional business financing than their Eastern counterparts did. West Coast venture capitalists usually invested as individuals, often as a sideline to their work with established financial organizations, through the 1950s. West Coast venture capitalists led the next wave of innovation in forming venture capital organizations.

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