The Risk Taking Gene:
a social and economic imperative

Merle Coe

President Bush's advocacy of an "Ownership Society" is an example of recent recognition given the economic contributions of entrepreneurship.[1] The extent to which America's economy is jeopardized by government policies restricting entrepreneurial activity, however, is less widely appreciated. Risk tolerance is arguably not merely an economic issue: it is a key indicator of a society's overall well being. It helps define humanity.[2]

When China's Confucian elite returned to historical "values" in 1433, they arguably paved the way for descendants of relatively primitive Europeans to dominate descendants of the most advanced society on earth. History is replete with examples of societies turning inward, away from risk taking. Such societies withered: quality of life declined. In the United States, Detroit's rejection of Deming's ideas wiped out dreams of a middle class life style for hundreds of thousands of American families. Today, suppression of genetic entrepreneurs in the name of "values" threatens U.S. leadership in what may be the 21st century's most important industry. Economic consequences of repressing other's talents, while wasting one's own, are addressed in this paper; the morality, is left to philosophers and spiritual leaders.[3]

Every citizen should care about entrepreneurs and small-to-medium sized enterprises (SMEs). The Small Business Administration (SBA) recently reported that SMEs create more than half of all new jobs in the U.S. economy. A companion 2003 SBA study also found SMEs were a major source of technological innovation. Even more impressively, SMEs accomplished this with minimal capital investment: roughly half the value created by the U.S. economy was produced with less than 10% of new capital invested in economic growth.[4] The factories that ground down the Thousand Year Reich were there when needed because of former pioneering efforts by countless wildcatters, Henry Ford's, and Alexander Graham Bell's.

Cultivation of successful entrepreneurs and SMEs is not only vital for our current economic welfare and future standard of living; it is vital for a healthy society. To deny dreamers and experimenters is to deny who we are and whence we come. Entrepreneurial drive resides in DNA: from the simplest life form to the most complex.[5] Consider HIV viruses: constantly morphing, evolving, and opportunistically defeating poisonous cocktails. Consider Edison's thousands of experiments to find the right filament. Entrepreneurial risk taking is a core part of our nature: we deny it at some peril.

A century ago inventors, America's founding fathers and early industrialists were hailed as heroes. The risks they took, the challenges they overcame were celebrated. Valiant failure was respected. Nathan Hale's, "I only regret I have but one life to give for my country" defiance of a king and Prometheus' defiance of Zeus are morality stories about individuals succeeding at rising above king and god through failure. Children in middle class families were weaned on the ruggedly individualistic self reliant don't-be-afraid-of-failure messages of Thoreau, Emerson, and Whitman.

[1] http://www.whitehouse.gov/news/releases/2004/08/20040809-9.html
[2] Stephen A. Boyko & Merle Coe; *The Ownership Society*; In the National Interest & The Nixon Institute, 2005
[3] Matthew 25: 14-30
[4] Stephen A. Boyko; *Small is Beautiful*; In the National Interest, No. 77 – Fall, 2004
[5] Ardrey, Robert (1966) *The Territorial Imperative*, New York: Antheneum Publishing

Today, the USA faces ominous trends. Today, relatively few adults are sufficiently literate to appreciate Thoreau, Emerson, or Whitman even if so inclined.[6] The message from TV and white shoe Republicans and Democrats is "conform." Entrepreneurial financing, defined as a percentage of total capital formation, decreased from 16.7 percent to 10.5 percent between 2000 and 2002. Going-private filings rose from 197 to 316, comprising 17 percent of all public takeovers in 2002. At the same time, government responses to the plague of "Enronitis," which includes tax relief and regulation, are not benefiting SMEs. While tax relief has stimulated the economy, the primary beneficiaries are well-capitalized corporations with established revenue streams. As well, the compliance costs associated with the Sarbanes-Oxley Act (SOX) and other top-tier regulation are particularly burdensome for SMEs.[7]

Contrast how a WWII soldier-inventor of hedge row hogs was treated versus Iraq Invasion soldier-innovators who welded armor plate on vehicles. More disturbing than the fact that warrant officers were court-martialed for initiative, is the dejected fatalism with which these entrepreneurial warriors accept their fate, "well, technically I was wrong." Thoreau and Prometheus would have spit on slugs who court-martialed them. More disturbing still is our mass doping of precocious urchins.

Mediocrity is promoted in the USA at the highest levels: Presidential Medals of Freedom[8] went to Brenner, Franks, and Tenet. A $90 million bonus is paid for dropping $7-10 billion on subprime loans. American auto executives who engineer their industry's train wreck collect billions in salary and bonuses. Half of all students at Ivy League schools receive A's,[9] 91% of Harvard seniors graduate with honors.[10] Johns Hopkins students earn credit for a "Sex, Drugs, Rock & Roll in Ancient Egypt" course.

C.S. Lewis succinctly sums-up U.S education policy[11] in *Screwtape Letters*, "Dunces and idlers must not be made to feel inferior to the intelligent and industrious." Not only have U.S. students fallen behind in mastery of basics,[12] their capacity to visualize what might be, to dream new dreams is atrophying.[13]

Could lack of epic challenge be at the root of student lethargy? Consider organisms examined in *Territorial Imperative*. All – including earthworms, wrens, and humans – live on a higher plane (have more energy, emit more body heat, accomplish more) when experiencing the responsibilities and challenges of turf (a nesting area, a farm, an industry transformation). Organisms without territory are more lethargic, less energetic.[14]

When schools do add an element of risk to curriculums, it is usually the mundane calculation of predictability form of risk. Read this material, answer these questions or you'll likely get a D. Rarely are students engaged in a higher, more creative *Epic Challenge* form of risk – the taking-on of the unknown, the dealing with uncertainty. Rarely are students challenged to develop a roadmap in uncharted territory with no certainty a road can be constructed, chasms spanned. A common trait of outstanding teachers is that they dole out subject matter turf, demand too much, force kids to "go to failure," and by so doing, live.

Conceivably, challenges such as overcoming stage freight on a debate team, or facing the fear of failure in a string theory project, may even produce sufficient endorphins to satiate adolescent appetites and moderate cravings for criminally induced buzz.

In setting out on their westward trek, the earliest pioneers faced an Epic Challenge of dealing with uncertain dangers and obstacles. Based on their experiences, those who followed could calculate with some degree of certainty that if they departed by such a date, and carried so much food, they had a high probability of reaching their destination.

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[6] Twenty times more American adults can identify five Simpson cartoon characters than name the five First Amendment rights (McCormick Tribune Freedom Museum*; Americans' Awareness of First Amendment Freedoms*; March 2006)

[7] Stephen A. Boyko & Aron A. Gotesman; *Understanding Entrepreneurs*; In the National Interest, 2004

[8] There were precedents. Varro, for example, was welcomed back to Rome after Hannibal annihilated his army at Cannae.

[9] Washington Post, *At Princeton, A Move Toward Fewer A's*; April 28, 2004, page A3

[10] Boston Globe, *Harvard's Honors Fall To The Merely Average;* October 8, 2001, page A1

[11] Lewis, C.S.; *The Screwtape Letters*; Preface to Screwtape Proposes a Toast; Macmillan Publishing, New York, 1982

[12] Fewer than 35% of college graduates are proficient in math; only 25% can read proficiently; U.S. Department of Education; *2003 National Assessment of Adult Literacy*

[13] Postman, Neil; *Amusing Ourselves to Death*; Penguin Books, New York, 1985

[14] Taylor suggests Ardrey views territorial imperative as more "hardwired" than do such authors as Malmberg. Taylor, Ralph B. (1988) *Human Territorial Functioning*, Cambridge: Cambridge University Press. Malmberg, T. (1980) *Human Territoriality*, New York: Mouton

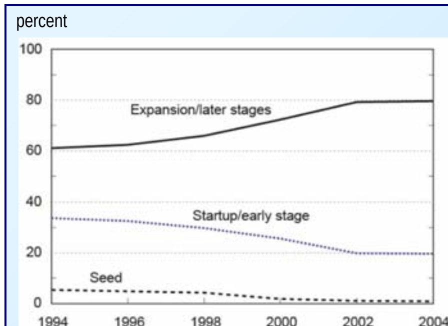
Society is improved by both forms of risk taking. But only those fortunate few who tackle Epic Challenges transform industries, cut the time it takes to send a message to Hong Kong from two months to two seconds, create a nation state based on a new vision of democracy, develop Quantum Mechanics, and hack matter.

The lesson? Unleash entrepreneurs. Encourage and celebrate those who strive. Embrace diversity. Tolerate failure. Participants live more fulfilled lives. Participants and non-participants alike enjoy higher standards of living. Government ministers gain a larger tax base. The alternative is slow stagnation at the societal level: a passive life of quiet desperation at the individual level. President Theodore Roosevelt said it best…

> *"It is not the critic who counts, not the person who points out where the doer of deeds should have done better. The credit belongs to the person who is actually in the arena; whose face is marred by dust and sweat and blood; who strives valiantly; who errs and comes up short again and again; who knows the great enthusiasms, the devotions, and spends himself in a worthy cause; who at best knows in the end the triumph of high achievement; and at the worst, at least fails while daring greatly; so that his place shall never be with those cold and timid souls who know neither victory or defeat."*

Islands of hope do exist. Immigrants, attracted by the American Dream, bring renewed vitality to small business.[15] *Heroes*, published by the National Neighborhood Grocers Association, is the account of a day in the life of a small grocer and her effect on the local community.[16] At the other end of the spectrum, firms such as Cash & Carry America and Data Quality Solutions are engaged in the transformation of major industries with profound implications for the U.S. economy if they are successful. This is the good news. The bad news is that the "seed stage" capital pool shrank steadily the past 20 years. Meanwhile: start-ups require significantly more seed capital than before to begin attracting institutional capital; and, start-ups spend more time in "seed stage."

In the financial market of 10-15 years ago, VC and private equity firms could wager on growing a seed stage company to $50 million or more within a five year investment window. In that model, $50 million was sufficient revenue to consider an IPO and 90% of VC portfolio company exits were IPOs (10% were M&A.) More than 20% of VC funding went to concept and seed stage companies. Entrepreneurs often attracted institutional funding after spending relatively little "friends and family" seed money to prepare a business plan, obtain concept validation, and develop a prototype. States such as Maryland set reasonable limits on what was essentially "friends and family" money that could be offered as unregistered stock without filing a state (as opposed to federal) notice. In Maryland, for example, the limit was $150,000.



Venture Capital Disbursements 1994-2004
By Stage of Financing
Source:
NSB *Science & Engineering Indicators 2006*

The "old" model no longer exists. The practical scale required of public companies is north of $1 billion and going higher. "Going privates" in the mid-size range of $500 million – $1 billion exceeds IPOs. Fewer than 10% of VC and private equity backed portfolio companies now exit via IPOs (90% are M&A) and VC funding of seed stage companies has been slashed 90%. Entrepreneurs now face a higher bar. Revenue of $2 million is the lower limit required for consideration by most sources of institutional capital. The lower limit is inexorably ratcheting higher.

Two factors are frequently cited for the change: NASD (now FINRA) culled small broker dealers specializing in small IPOs; and, SOX and other regulation dramatically increased the cost being a public company. Other factors also contributed. Regardless of the reasons, the changes gave rise to unintended consequences.

In the old model, "friends and family money" could reasonably hope that a VC would bring in a professional management team prior to the passage of "too much" time and before operations became "too complex." In the new model, entrepreneurs need more seed funding to reach "exit" than the states' "friends and family scenario" oriented reporting caps anticipated. Corporate governance and compliance complexity have

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15 Friedman, Thomas L., *The World Is Flat: A Brief History of the Twenty-first Century*, (April 2006) Farrar, Straus & Giroux,
16 NNGA, *Heroes: Realizing the American Dream*; 2002

increased. As "rules" grow more complex and conflicted, the sources to which entrepreneurs can turn for assistance and guidance are dwindling. Less than 0.1% of broker dealers engage in private placements for seed stage capital. Entrepreneurs wishing to raise start-up capital must largely do it themselves. In doing so, they face a minefield: the SEC and FINRA delegation of some seed stage turf to the states created a patchwork of inconsistent and contradictory standards. NASAA is little more than a trade union whose members squabble over jurisdiction and work rules with the SEC and FINRA. State regulators (NASAA members) have little incentive to promote order: confusion breeds job security, contention inflates staffing levels. Some state Security Commissions, such as Maryland's, are regularly accused of entrepreneurial jihad – with allegations ranging from self dealing to fraud upon the court in pursuit of career agendas.

Public interest is poorly served by such "oversight." Investors find the increasingly dense state-by-state notices and other state mandated boilerplate intimidating: the effective result being less transparency, not more. Entrepreneurs are largely on their own in figuring out how to negotiate the minefield. B-school curriculums are strangely silent about seed stage finance and governance. It is entirely possible to receive an MBA without being exposed to the "504-506 D" exceptions to the Securities Act of 1933, let alone state standards for unregistered securities. Securities attorneys, accountancies, broker/dealers, and economic development commissions are largely unfamiliar with the area. Securities commissions in Maryland and Virginia, for example, regularly apply different interpretations of "rules" to seed stage companies that have received grants from the states' economic development organizations than to companies that have not.

It has been the author's experience that entrepreneurs, almost without exception, are eager to comply; but, are understandably confused about how to comply. When questions arise, hair triggers on some regulators' "subpoena guns" do little to provide needed guidance. Too often, such action causes entrepreneurs to "go underground" and restart or take "regular" jobs. (Raising capital for a start-up is difficult enough without the added challenge of an overhanging subpoena, the usual resolution of which is years of regulator silence.) In either case, collateral damage includes prior investors losing their investments. In the latter, communities miss out on the economic potential of what might have been.

As always happens in market economies, solutions emerge to fill evolving needs. Management consulting boutiques, support networks and other resources are beginning to meet the new needs of entrepreneurs. Entrepreneurship *is* a contact sport and "Seed Stage Advocacy" has become a concept with some currency.

Networks such as Corporate Finance, Inc. (CFI), 270TECH, and Teton Sands nurture early stage companies and budding entrepreneurs. Over the past decade, CFI helped more than 300 entrepreneurs and seed stage companies: establish corporate governance and compliance practices; streamline operations; and, strengthen their advisory boards and management teams. CFI's President, Thomas Trexler has been a particularly effective advocate for small business: in 15 years, none of his firm's clients have been penalized for governance or compliance issues. The Artemis family of funds (managed by unpaid volunteers) has helped hundreds of emerging companies obtain their first institutional funding in exchange for a "small sliver" of equity. The Artemis Global Technology Fund, for example, provided early-stage capital in support of Abol Coffee's vision which includes empowering hundreds of thousands of African small coffee farmers. In 2004, MBRT established its Venture Capital Fund for minority owned businesses.

Behind the scenes, support is growing for the Entrepreneurial Exchange – an exchange where certified, sophisticated investors trade shares of privately held companies with minimal bureaucratic red tape.[17] The START360 Forum series, scheduled to begin the 4th quarter 2007, is dedicated to increasing seed stage capital formation transparency and promoting standards of "best practice." *Commission Purgatory*, to be published 1st quarter 2008, offers a useful inside perspective despite its somewhat overly dramatic tone. *Seed Stage Advocacy*, a 270TECH White Paper, is an analysis of capabilities and characteristics that entrepreneurs might well consider as they seek out and choose corporate advisors. In promoting an understanding of and access to due process, the Due Process Institute (DPI) makes a contribution by helping to level the playing field on which innovators and regulators contend.

For information about White Papers, our practice partners and concept stage enterprises, contact:
R. Sells
rsells@corporatefinanceinc.com

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[17] For a more detailed explanation of the Entrepreneurial Exchange reference: Entrepreneurial Exchange (October 2003) http://www.buyside.com/archives/2003/0310/html/0310gst.asp