Whitepaper

Venture Beyond Borders: Can Sanction Compliance Anchor Expansion in the Global Economy for VCs?

AML Watcher

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Introduction

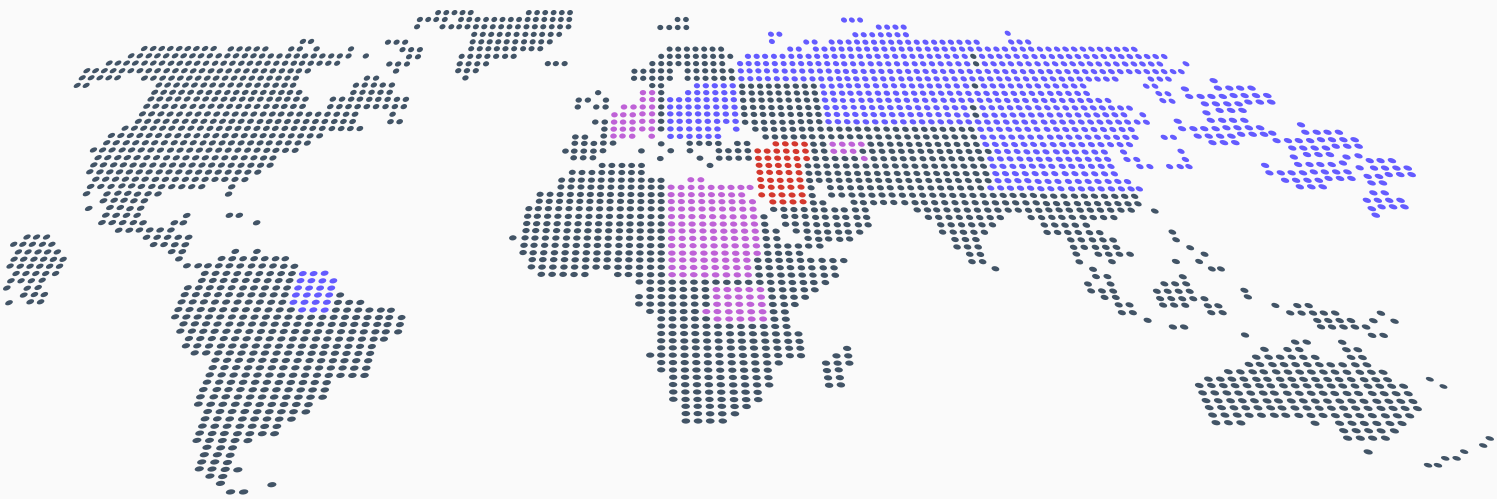
More often than not, at the mention of venture capital, many envision Kevin O'Leary from Shark Tank emphatically declaring, "you are dead to me," or Mark Cuban announcing, "I'm starting my 24-second shot clock.

While this portrayal does capture an aspect of venture capital where founders and innovators pitch to a high-energy board or panel of billionaires or multimillionaires within a limited time frame, it is not the entirety of what venture capital entails.

In some instances, venture capital operates similarly to Shark Tank, emphasizing quick decision-making and high-stakes presentations. However, venture capital, in its entirety, goes beyond this dynamic. Simply put, venture capital is defined as:

> " Venture capital (VC) is a long-term, hands-on equity investment in privately held, high-growth-potential companies, initiated and managed by professional investors."

Put differently, according to Aizenman and Kendall, venture capital can be categorized based on the investment stage, including seed, startup, early stage, and expansion stage transactions. These stages signify the initial phases a company experiences as it advances toward becoming an operational corporation, establishing stable revenues, and cultivating a defined product and customer base. Ultimately, this progression holds the potential for issuing shares through an IPO [or other exit strategies

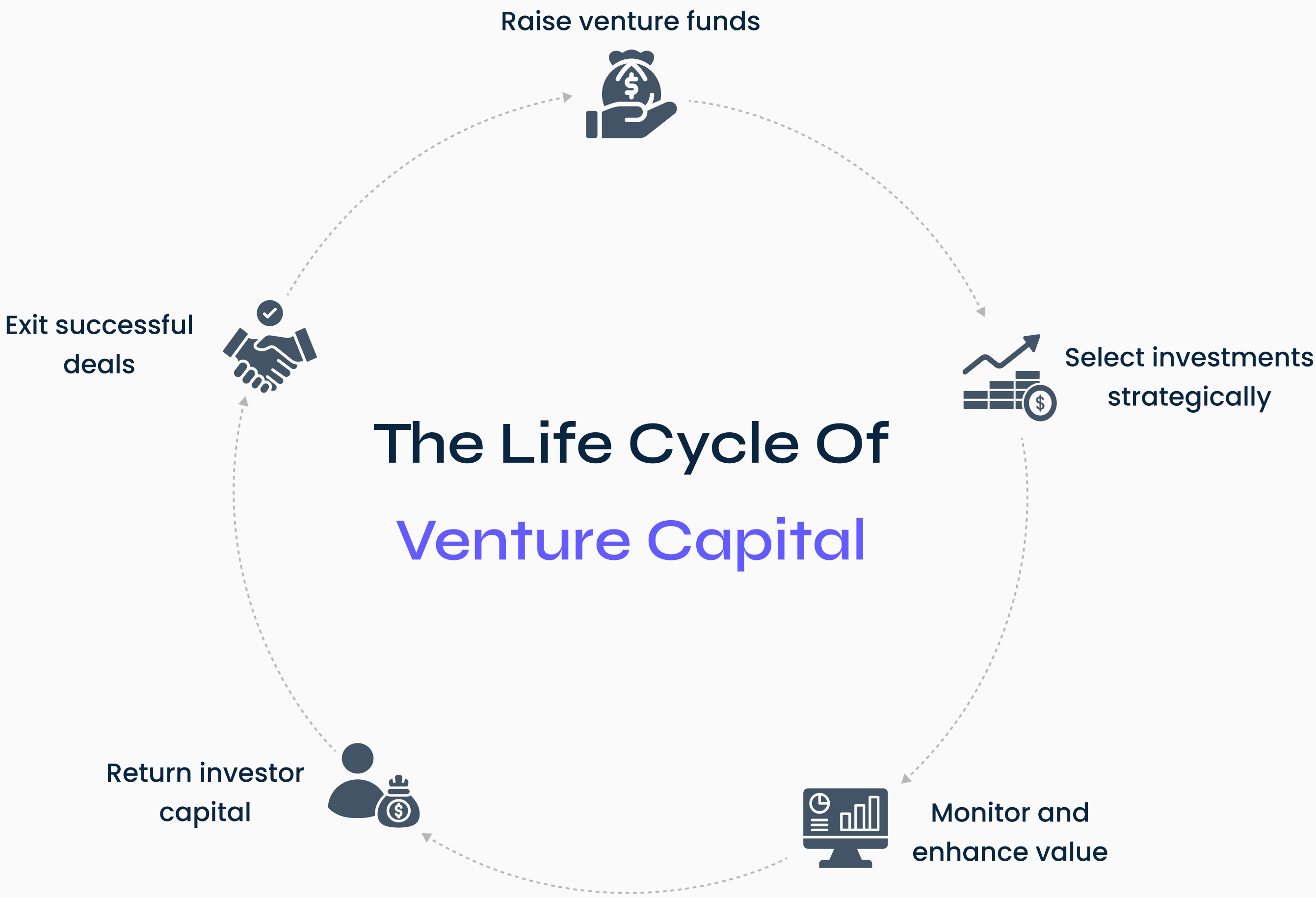


1. The Internationalization of Venture Capital and Private Equity. (2023, November 7). Retrieved January 8, 2024, from http://www.nber.org/papers/w14344

The Life Cycle Of Venture Capital

Gompers and Lerner explain the Life Cycle of Venture Capital through the following steps

- Raise venture funds
- Select investments strategically
- Monitor and enhance value
- Return investor capital
- Exit successful deals



2. The Venture Capital Cycle, second edition. (n.d.). MIT Press. Retrieved January 8, 2024, from https://mitpress.mit.edu/9780262572385/the-venture-capital-cycle/
3. THE INTERNATIONALIZATION OF VENTURE CAPITAL AND PRIVATE EQUITY. (2023, November 7). Retrieved January 8, 2024, from http://www.nber.org/papers/w14344

Venture Capital in a Global World

Globalization, like every other facet of the financial world, has opened up numerous opportunities for venture capital. However, it has yet to permeate the venture capital landscape to the extent seen in other domains. Since it is a phenomenon originating in the United States post-World War II, the concentration of venture capital remains notably high in the U.S. compared to the rest of the world.

As Aizenman and Kendall observed:

"While the venture capital sector in the United States has been large and vibrant for many years, the rest of the world experienced minimal growth in venture capital activity until the mid-1990s. Since then, the internationalization of the venture capital sector has been driven by both general factors propelling globalization and historical specifics unique to venture capital."

In the current landscape, where opportunities are abundant in the Asia and MENA regions, the venture capital sector's hesitance/inability to embrace global expansion proves costly. This reluctance not only results in missed opportunities for the industry but also hinders startups in these regions from accessing crucial capital. Furthermore, this trend perpetuates a concentration of venture capital activities within the U.S., focusing on specific sectors.

A significant contributing factor to this phenomenon lies in the challenges associated with navigating a complex array of regulations, both locally and internationally, especially concerning sanction compliance. Addressing these regulatory challenges becomes paramount for the venture capital sector to unlock its full potential in a globally diverse market.

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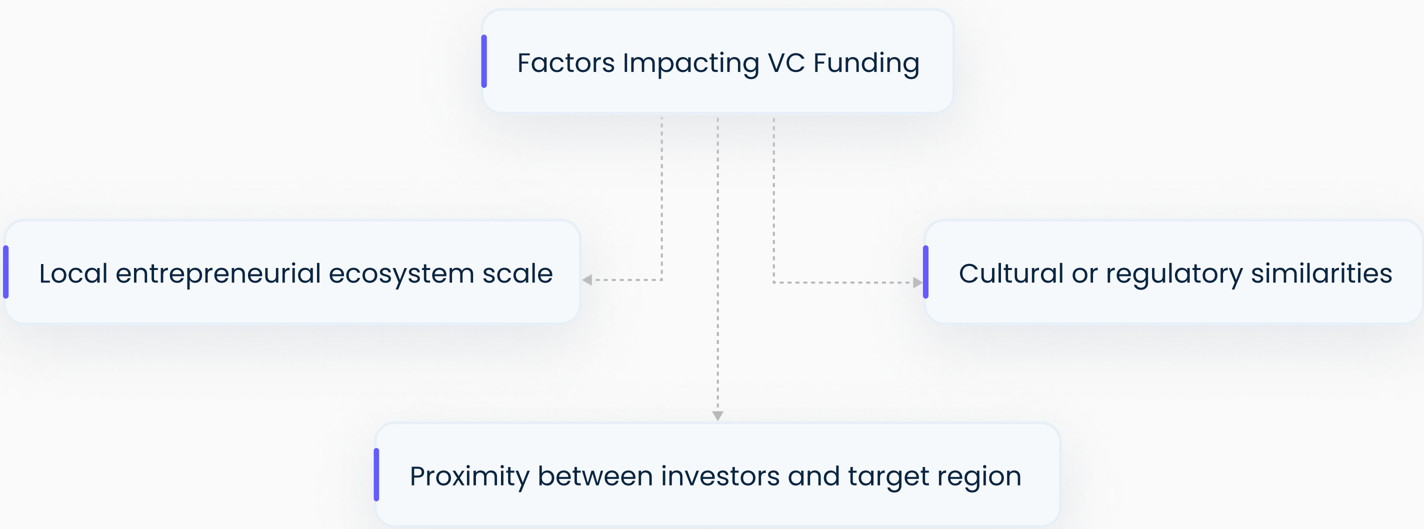
Gravity Model and Venture Capital's Dilemma

Similar to the economic gravity model, the basic gravity model in venture capital serves as a framework for scrutinizing the geographical dynamics of investment flows within the venture capital industry.

Drawing inspiration from the principles of the gravity model in economics, which explains the exchange of goods and services between two locations based on their economic sizes and the distance between them, the venture capital gravity model delves into factors shaping investment patterns among regions.

Within the venture capital context, this basic gravity model considers variables such as the scale of the local entrepreneurial ecosystem, the proximity between investors and the target region, and potentially additional elements like cultural or regulatory similarities. The fundamental concept underlying this model posits that venture capital investments are inclined to gravitate towards regions boasting larger and more dynamic startup ecosystems, coupled with closer geographical proximity.

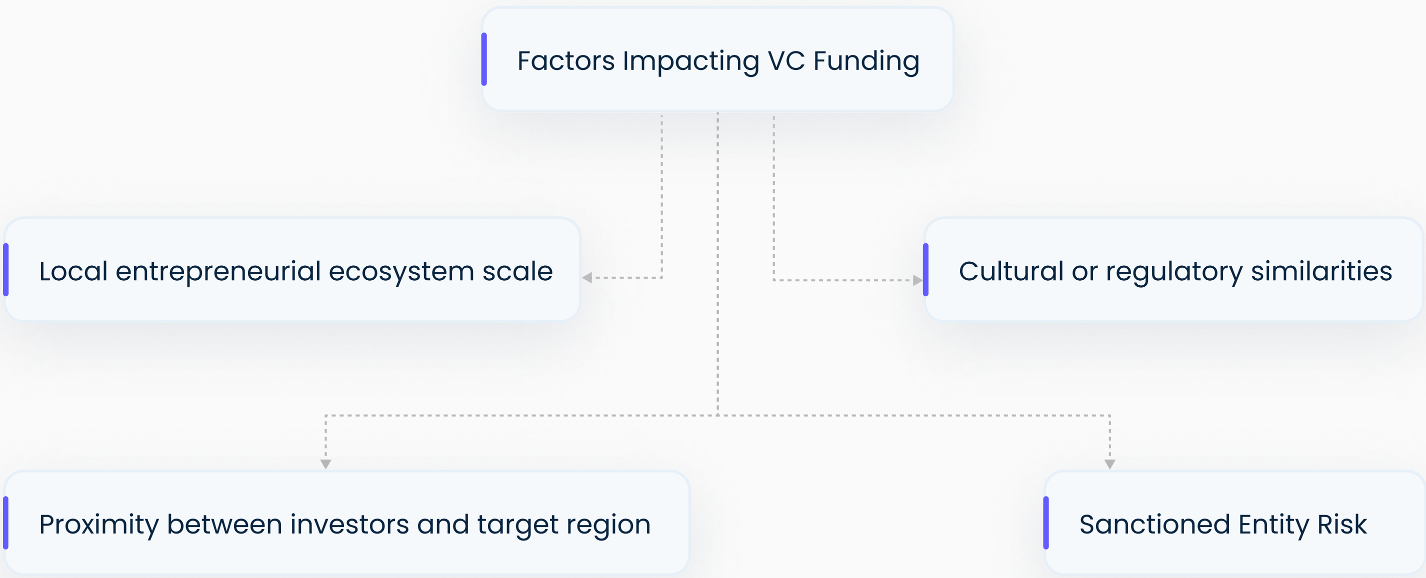
Venture Capital Gravity Model



The above model paints a vivid picture of the factors impacting VC funding. However, there is another critical risk factor that must be considered, and that is the primary subject of this white paper—the risk of dealing with sanctioned individuals or entities. VCs might not be aware of or may lack the means to ascertain if a particular entity is sanctioned. In other words, in addition to the trifecta of issues that VCs already face, this presents a fourth significant challenge.

Having stated that, the issue of sanctioned entity risk not only pertains to startups but also affects the investors supporting the VC fund. Another crucial dimension to consider is that of incubators, such as Y Combinator. While these incubators play a vital role in preparing startups for the market and investment rounds, their reach is still limited, especially in regions like Africa and Asia where the potential for startup innovation is significant. Once again, sanction screening poses a substantial barrier to the expansion of incubator initiatives in these markets.

Venture Capital Gravity Model (Updated)



This model not only aids researchers and practitioners in understanding the complexities of venture capital investments but also facilitates the prediction of investment patterns. Additionally, it assists in identifying potential factors that influence the distribution of venture capital across diverse regions.

Case Study:

Rusnano USA: A Covert Venture

Rusnano USA, a venture established by Russia's government-owned venture capital firm, Rusnano, has come under suspicion for alleged covert technology transfer activities. Rusnano USA, with a focus on nanotechnology acquisitions, is accused of not only acquiring technology but also infiltrating venture capital groups in Silicon Valley, functioning as an intelligence platform for Russian operations.

FATF Recommendations vis-a-vis Sanction Screening

The issues related to sanctioned entity risk, particularly in the context of startups, investors, and incubators, are addressed by several FATF recommendations.

- Recommendation 6 focuses on targeted financial sanctions related to terrorism and terrorist financing, urging countries to implement regimes compliant with UN Security Council resolutions in this regard.

- Recommendation 7 extends similar targeted financial sanctions to proliferation activities, emphasizing the prevention, suppression, and disruption of weapons of mass destruction proliferation and its financing.

- The necessity for robust customer due diligence measures, as outlined in Recommendation 10, becomes apparent in the prevention of dealings with sanctioned entities.

- Additionally, Recommendation 11 emphasizes the significance of record-keeping by financial institutions, ensuring the availability of transaction records for at least five years.

4 . The Venture Capital Cycle, second edition. (n.d.). MIT Press. Retrieved January 8, 2024, from https://mitpress.mit.edu/9780262572385/the-venture-capital-cycle/

- Lastly, Recommendation 16 addresses wire transfers, emphasizing the inclusion of accurate originator and beneficiary information to prevent transactions involving sanctioned entities.

These recommendations collectively form a comprehensive framework for mitigating the challenges posed by sanctioned entities and fostering a secure financial environment.

The Need for Venture Capital Funds to Go Global

In a manner of speaking, the gravity model appears to elucidate the reluctance of venture capitalists to invest in various regions, such as Asia and the MENA region. Despite these geographical areas being rife with opportunities, the perceived risks present themselves as significant deterrents.

Consequently, the majority of investments tend to remain localized. Furthermore, there exists an information asymmetry between VCs and investors. While investors may possess extensive knowledge about the international market, founders often hold superior insights into the local market, including formal and informal regulations in their home countries. In both scenarios, this informational asymmetry creates a trust deficit, with the potential for either party to exploit or manipulate the other.

This trust deficit becomes particularly pronounced in high-stakes situations, such as those involving sanctions. When VCs lack awareness of the multitude of sanctions that could be imposed on specific sectors in certain countries, the implications extend beyond financial or monetary penalties. They can also have ramifications for national security. Consequently, VCs become wary of investing in companies where such uncertainties exist. However, it's crucial to note that other issues, such as money laundering and criminal enterprises masquerading as start-ups, add another layer of complexity to the investment landscape.

This begs the question: Why should venture capitalists engage in complex global investments, grappling with regulatory hurdles and sanction screening, when they can continue to invest in local startups and reap the benefits without the added challenges? The answer lies in the transformative potential of these startups to address the developmental challenges faced by underdeveloped regions. Before probing into this, it's crucial to explore why there is a compelling need for such global engagement.

Exploring healthcare-focused startups, especially in Africa, highlights the necessity for venture capitalists to expand their influence beyond local boundaries. Recognizing the transformative potential of these startups in addressing health challenges, VCs can play a crucial role in fostering innovation and sustainable solutions on a broader, global scale—all while turning a profit.

So, what is the solution? Should VCs continue as is, operating in a localized landscape, investing in local start-ups, and remaining mainly a local phenomenon? Or should start-up founders relocate to the US in droves?

These are two extremes that do not address the problem; instead, they avoid it. This issue can be partly resolved with data-driven sanction screening, which can alleviate one of the biggest headaches for VCs.

Data-Driven Sanction Screening

Sanction screening refers to the process of systematically checking individuals, entities, or transactions against lists of sanctioned or restricted parties. These lists are often maintained by governmental bodies, international organizations, or regulatory authorities.

The primary goal of sanction screening is to ensure compliance with national and international regulations, preventing businesses and financial institutions from engaging in transactions with sanctioned entities.

Data-driven sanction screening takes the process a step further by leveraging advanced technologies and analytical tools. Instead of relying solely on predefined lists, data-driven approaches incorporate a broader range of information sources, including dynamic and real-time data. This method involves the use of artificial intelligence, machine learning, and big data analytics to enhance the accuracy and efficiency of sanction screening.

Data-driven sanction screening not only automates the compliance process but also provides a more comprehensive and adaptive solution compared to traditional, rule-based screening methods.

Furthermore, the data-driven approach ensures a nuanced understanding of entities, considering contextual factors and reducing the likelihood of false positives. This adaptability enables businesses to stay ahead of emerging risks and regulatory changes, fostering a proactive compliance stance.

Geopolitical Landscape and Data-driven Sanction Screening

In the context of an ever-evolving geopolitical landscape, characterized by ongoing tensions and regulatory actions, the importance of data-driven sanction screening for businesses becomes increasingly evident.

Notably, geopolitical events such as the imposition of economic sanctions on Russia in response to the Russia-Ukraine war underscore the need for companies to navigate the resulting surge in financial, operational, and reputational risks. To effectively manage these risks and comply with evolving regulations, businesses must establish robust sanctions screening systems. The challenge lies in conducting efficient and accurate screening amidst continuous changes in denied parties lists and complex global sanction rules.

Executive Order 14083 issued by the Biden Administration[5]

Executive Order 14083, issued on September 15, 2022, emphasizes the United States' commitment to foreign investment while ensuring robust consideration of evolving national security risks. Underlining the importance of open investment, the order acknowledges potential national security threats from certain foreign investments, particularly those involving countries with strategic technology or infrastructure goals. The order directs the Committee on Foreign Investment in the United States (CFIUS) to expand its review process, considering factors such as supply chain resilience, cybersecurity risks, and national security concerns related to sensitive data. Additionally, it emphasizes periodic reviews and updates to adapt to changing national security landscapes, aiming to balance foreign investment benefits with safeguarding U.S. interests.

This order epitomizes how countries are taking the safeguarding of their investments seriously, ensuring that investors comply with regulations. Also, it showcases the commitment of the US to foreign investment while acknowledging the need for a robust review process to address evolving national security risks. Put differently, data-driven compliance solutions are the doorway to the future.

5. Presidential Documents. (2022, September 20). GovInfo. Retrieved January 9, 2024, from https://www.govinfo.gov/content/pkg/FR-2022-09-20/pdf/2022-20450.pdf

Manual screening, especially during periods of geopolitical uncertainties, proves disadvantageous, emphasizing the necessity for automated systems supported by intelligent technology, like AML Watcher sanctions screening, to ensure compliance at every point of exposure to external parties.

By transforming challenges into opportunities, technology-forward solutions like AML Watcher enable VCs to embrace a broader global perspective without the weight of hesitation or other worries bogging them down. By adeptly managing regulatory complexities, data-driven sanction screening allows venture capitalists to focus on their innate strengths—exploring and investing in the multitude of opportunities that the evolving global stage presents, all the while contributing to the creation of a more equal and habitable world.

AML Watcher

Turn Insights into Strategy

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