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SEC SIGNALS NEW ENFORCEMENT INTEREST IN VENTURE SPACE

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The Securities and Exchange Commission (SEC) recently announced both the Division of Enforcement's results for fiscal year 2023 and the Division of Examinations' exam priorities for 2024. The enforcement results highlight that the SEC continued its perennial focus on conflicts of interest, calculation of management fees, allocation of expenses, and valuation practices at private fund advisers, including advisers to venture capital funds. But the 2024 examination priorities signal that new enforcement areas may be on the horizon for venture fund advisers. Especially noteworthy is the Commission's stated interest in the due diligence practices of venture capital fund advisers in connection with their assessments of prospective portfolio companies. (Securities and Exchange Commission 2024 Examination Priorities at 11.)

The SEC's traditional focus in venture capital enforcement

Of the 501 stand-alone enforcement actions initiated by the SEC in 2023, 17% involved investment companies or advisers. This category includes advisers to venture capital funds. Although venture-fund advisers are exempt from the obligation to register under the Investment Advisers Act of 1940 ("Advisers Act"), some are nonetheless registered - and the SEC has the authority under Section 206 of the Advisers Act to police fraudulent conduct by an adviser whether the adviser registers or not.

To date, the actions the SEC has brought against venture-fund advisers have focused primarily on instances of fund mismanagement, conflicts of interest, excessive management fees, and pay-to-play vio-\Another example of the SEC's traditional enforcement agenda in the venture space involved venture funds SparkLabs Management, LLC and SparkLabs Global Ventures Management, LLC. (https://www.sec.gov/enforce/ia-6121-s.) Over the course of more than three years, these funds allegedly made more than 50 loans to affiliated funds in violation of internal policies. The SEC alleged that the adviser (and an individual principal) failed to consider and disclose potential conflicts of interest to investors.

Similarly, the SEC recently brought a number of enforcement actions against venture fund advisers for overcharging fees on invested capital, including one such matter involving exempt-reporting adviser Energy Innovation Capital Management, LLC (EIC). (https://www.sec.gov/news/press-release/2022-154.) The SEC alleged that EIC failed to adjust ma-









nagement fees on invested capital according to requirements in its limited partnership agreements and inaccurately calculated management fees in various ways. These errors allegedly led EIC's limited partners to pay nearly $700,000 more than they should have paid in management fees. (https://www.sec.gov/litigation/admin/2022/ia-6104.pdf.)

A new priority focused on venture capital advisers

The 2024 Examination Priorities state that the SEC will continue to scrutinize the perennial conflicts and fees issues described above by investment advisers of every stripe. Notably, however, 2024 marks the first year the SEC has called out venture-fund advisers specifically, noting that it will prioritize a review of "[d]ue diligence practices for consistency with policies, procedures, and disclosures, particularly with respect to private equity and venture capital fund assessments of prospective portfolio companies." (https://www.sec.gov/files/2024-exam-priorities.pdf at 11 (emphasis added)). The prioritization of venture fund advisers' due diligence practices suggests that the SEC may increase the number of examinations of exempt reporting advisers and take a more granular look at firms' core internal processes for conducting due diligence.

This new area of interest could present challenges for both the Commission and venture fund advisers. Given the different business models, due diligence processes at venture funds typically look very different from those at private equity funds, with which the SEC may have more familiarity. For example, seed stage venture funds may invest in little more than an idea or a team. The due diligence process for such an investment may differ dramatically from an investment by a private equity fund in a later-stage operating company with a track record and more sophisticated internal policies and controls. This means that risks are often managed differently at venture firms, raising questions about whether the SEC will tailor its examination process to account for the unique nature of venture capital.

Moreover, the SEC has fewer and blunter tools to deploy against venture-fund advisers who are exempt from registration and therefore not subject to many of the provisions of the Advisers Act, including the custody rule, the marketing rule, the record-keeping rule, and the proxy voting rule. That said, the SEC does have the authority to bring charges against venture capital fund advisers under the anti-fraud provisions of Section 206, and, as noted in the priorities, will carefully scrutinize disclosures to determine if advisers are following disclosed due diligence practices. The SEC will also have the benefit of hindsight when assessing whether advisers conducted adequate diligence on a portfolio company that ultimately proved to be a poor investment.

There is no mistaking the import of the SEC's specific reference to venture capital funds in its newest list of priorities, signaling that venture capital fund advisers may be subject to both a wider and closer inspection by the SEC. Venture-fund advisers should take care to ensure that diligence practices are fully disclosed and observed, and that policies are compliant with the provisions of the Advisers Act that apply to exempt reporting advisers.

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