

# Opportunities for U. S. Venture Capital Funds and Start-up Companies Operating Under New FIRRMA Regulations During COVID-19

---

July 1, 2020

---

**PRACTICES** International, Investment Management, Asia, U.S. Inbound Investment, Emerging Companies and Venture Capital

---

The COVID-19 pandemic has lasted for over four months, and there is no sign that the number of new cases will decrease soon, though many states, companies and service providers are proceeding with the re-opening of business. The unexpected downturn in the economy caused by the pandemic has adversely affected VC financing opportunities for startups. On top of that, newly enacted regulations under the Foreign Investment Risk Review Modernization Act of 2018 (“FIRRMA”) place additional obstacles on foreign sources of VC funding, especially Chinese funds, in the high-tech area.

Until the passage of FIRRMA, the authority of the U.S. multiagency Committee on Foreign Investment in the United States (“CFIUS”) extended only to situations where a foreign entity made a controlling investment in a U.S. business. FIRRMA, however, expands CFIUS’s authority to cover minority investments made by foreign investors in “covered transactions.” These include foreign investments in a U.S. company that produces, designs, tests, manufactures, fabricates, or develops one or more “critical technology” or controls specified “critical infrastructure” or that would permit access to “sensitive personal data” of U.S. citizens (collectively “U.S. TID Portfolio Companies”). Moreover, foreign investments in critical technology or investments made by foreign government-backed funds in U.S. TID Portfolio Companies will trigger mandatory reporting, another new aspect of FIRRMA. This will greatly increase the uncertainty and costs for VCs and startups in structuring deals.

## US Funds’ Opportunity

FIRRMA, however, specifically carves out a U.S. “Investment Fund” exception<sup>1</sup>. With careful planning and well drafted fund documents, a qualifying U.S. fund is allowed to receive foreign funds and invest in “covered transactions” subject to these restrictions:

1. The fund must be controlled and managed exclusively by a U.S. general partner or fund manager.
2. The fund must not be indirectly controlled by any foreign person, entity or government.

To claim such exemption, the fund’s general partner or fund manager must ensure that:

1. Any foreign investor should not have the authority to control the fund, including the authority to approve, disapprove, or control investment decisions of the fund and decisions made by the general partner or fund manager, to control or unilaterally dismiss, prevent the dismissal of, select, or determine the compensation of the general manager or fund manager.
2. If the advisory board or committee of the fund consists of foreign investors, it should not have the ability to approve, disapprove, or otherwise control any investment decisions of the fund

or decisions made by the general partner or fund manager regarding portfolio companies held by the fund.

3. Any foreign investor should not have any access to “material nonpublic technical information”<sup>2</sup> of any of the fund’s U.S. TID Portfolio Companies as a result of its participation on the advisory board or committee.

## **Fund Structure and Term Considerations**

1. A U.S. fund should try to avoid having foreign investors on the advisory board. If the fund does allow foreign investors on the advisory board, their authority needs to be carefully limited and clearly stipulated.
2. Consider excluding any foreign investors from the board (or being an observer) of the fund’s U.S. TID Portfolio Companies.
3. Avoid government-backed sovereign funds.
4. Use side letters to exclude a foreign investor from being granted information rights (except the right to obtain financial information) of the fund’s U.S. TID Portfolio Companies.
5. Do not permit co-investment by foreign investors nor any direct investments in the fund’s U.S. TID Portfolio Companies.
6. Consider SPVs that only allow US investors to make investments in the fund’s U.S. TID Portfolio Companies.
7. Where foreign investors are involved in the negotiation of management fees, those management fees must be fairly negotiated. Foreign investors cannot unilaterally amend fund documents to change the fees paid to the general partner or the fund manager.
8. Include CFIUS language in fund documents and investor questionnaires. As this area of law keeps evolving, the fund needs to regularly review and update the fund’s investment policies and processes as well as the language in the fund documents to comply with current laws and regulations.

Note that FIRRMA explicitly states that a waiver of a potential conflict of interest, a waiver of an allocation limitation, or a similar provision, applicable to a transaction pursuant to the terms of an agreement governing an investment fund would not be considered as the foreign investor having the ability to control the fund.

## **FIRRMA Restrictions Only in Specific Areas**

The CFIUS mandatory reporting requirements currently cover only foreign investments in industries involved in critical technology or investments made by foreign government-backed funds in U.S. TID Portfolio Companies. (Of course, CFIUS filings, while not mandatory, are still highly prudent in many other situations, including those involving critical infrastructure, sensitive personal data, and real estate located in proximity to specified US national security assets).

From November 2018 until the present time, only critical technologies in 27 designated industrial sectors have been subject to mandatory CFIUS critical technology notification requirements. That is

expected to change, however, as CFIUS has proposed regulations that would link mandatory filings to all industries with products or technology subject to certain levels of US export control. Under current geopolitical environment, such export controls are more likely to apply to China than to U.S. ally countries such as the United Kingdom, Australia or Japan.

## Conclusion

U.S. VCs should consider looking to foreign markets such as China and Hong Kong to raise additional funds because VCs can structure funds that offer foreign capital an attractive way to invest in U.S. TID Portfolio Companies that are no longer available for direct foreign investment. This could benefit both the VC – by expanding the pool of available capital – and the foreign investors. U.S. funds should work with their counsel to closely monitor the development of CFIUS laws and regulations to potentially take advantage of this opportunity while being careful to avoid costly mistakes in structuring and operations.

For additional information please contact any member of Haynes Boone's [Emerging Companies and Venture Capital Practice Group](#).

---

<sup>1</sup> Currently under FIRRMA, an "Investment Fund" is exempt from the mandatory reporting requirement if "(i) the fund is managed exclusively by a general partner, a managing member, or an equivalent; (ii) the general partner, managing member, or equivalent is not a foreign person; (iii) the advisory board or committee does not have the ability to approve, disapprove, or otherwise control: (1) investment decisions of the fund; or (2) decisions made by the general partner, managing member, or equivalent related to entities in which the fund is invested; (iv) the foreign person does not otherwise have the ability to control the fund, including the authority: (1) to approve, disapprove, or otherwise control investment decisions of the fund; (2) to approve, disapprove, or otherwise control decisions made by the general partner, managing member, or equivalent related to entities in which the fund is invested; or (3) to unilaterally dismiss, prevent the dismissal of, select, or determine the compensation of the general partner, managing member, or equivalent; (iv) the foreign person does not have access to material nonpublic technical information as a result of its participation on the advisory board or committee; and (v) the investment otherwise meets the requirements of this subparagraph." See Section 1703(4)(D)(iv)(I) of FIRMMA.

<sup>2</sup> Under FIRRMA, the term "material nonpublic technical information" means information that: (i) provides knowledge, know-how, or understanding, not available in the public domain, of the design, location, or operation of critical infrastructure; or (ii) is not available in the public domain and is necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods. It does not include financial information regarding the performance of a U.S. business. See Section 1703(4)(D)(ii) of FIRMMA.