CLIENT ALERT

The 2018 CFIUS Amendments: Ten Questions Venture Capital Fund Managers and Investors Need to Answer

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For venture capital (VC) fund sponsors and investors – particularly (1) VC funds focused on investing in certain emerging and critical technologies, (2) VC funds with significant investor participation from sensitive jurisdictions, and (3) managers utilizing alternative structures or structures that provide investors with greater participation, access and information than customary for traditional well-established VC funds – the 2018 CFIUS amendments may impact the structuring of their funds and, once their funds have completed fundraising, the manner in which they make investments and interact with their investors.

CFIUS stands for the Committee on Foreign Investment in the United States. CFIUS has responsibility for reviewing certain transactions involving foreign investment in the United States ("Covered Transactions") to determine the effect of such transactions on the national security of the United States. Chaired by the Secretary of the U.S. Treasury, CFIUS is comprised of nine federal departments and offices, plus an additional five that may participate depending on the investment issues raised.

On August 12, 2018, President Trump signed into law the Foreign Investment Risk Review Modernization Act of 2018 (the "Act"). The Act reflects Congressional concerns about the changing nature of foreign investment and national security threats since the last update of CFIUS scope and authority in 2007. The Act amends timelines, establishes fees for transactions, enhances accountability, codifies certain existing CFIUS practices and expands others, including the Congressional role. Importantly, the Act makes clear that the U.S. should "continue to review transactions for the purpose of protecting national security and should not consider issues of national interest absent a national security nexus." This is in contrast with investment screening mechanisms in some other countries that look at factors beyond national security.

Within this overall framework, there are a number of specific questions fund managers and investors need to answer, including the following:

1. ***Is my investment strategy affected by the 2018 CFIUS amendments?***

The Act affects both control and minority investments. Of particular interest for VC funds, the Act gives CFIUS express authority to review:

- Any investment by a foreign investor in any unaffiliated "U.S. business" that (1) owns, operates, manufactures, supplies or services critical infrastructure; (2) produces, designs, tests, manufactures, fabricates or develops one or more critical technologies; or (3) maintains or collects sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security.
- Changes in any investment by a foreign investor described in the preceding bullet as well as transactions designed to evade CFIUS' jurisdiction.

- Other (non-investment) transactions by a foreign investor that give the foreign investor (1) access to any material nonpublic technical information in the possession of the U.S. business; (2) membership or observer rights on the board of directors or equivalent governing body of the U.S. business or the right to nominate an individual to a position on the board of directors or the equivalent governing body or (3) any involvement, other than through voting of shares, in substantive decision-making of the U.S. business regarding any of the matters described in the first bullet above (referred to in the Act as an "Other Transaction").

For these purposes:

- "U.S. business" means a "person engaged in interstate commerce in the United States." In a noteworthy expansion from previous law, a "U.S. business" is no longer limited to the portion of a business in the United States.
- "Critical infrastructure" means "systems and assets, whether physical or virtual, so vital . . . that the incapacity or destruction of such systems or assets would have a debilitating impact on national security." Regulations will further define "critical infrastructure," but it is logical to assume it will include elements as varied as power grids to potentially critical telecommunications or switching technologies.
- "Critical technologies" means certain defense-related articles or services; export controlled items; nuclear equipment, parts, components, materials, software and technologies and facilities; certain "agents and toxins"; and "emerging and foundational technologies" controlled under the new Export Control Reform Act of 2018 passed in conjunction with the Act.
- "Investments" cover both equity as well as "contingent equity" investments (which could presumably include convertible debt instruments as well as SAFEs).

Managers should be aware that there is, intentionally, no size limitation on transactions subject to the Act, as a result of Congressional concern around foreign investment in and acquisition of emerging technologies deemed critical to the national security of the United States. CFIUS thus has discretion to consider a broad range of investments as "Covered Transactions," although by regulation and practice this may be circumscribed. For this reason, even small funds, as well as funds focused on minority and seed or other early stage investments (including as part of an accelerator or incubator), need to consider potential CFIUS implications when structuring their funds.

2. *Are there any express carve-outs from CFIUS jurisdiction that I can rely on?*

Investments by a foreign person in a "U.S. business" indirectly through an investment fund are excluded from being an "Other Transaction" if (1) the fund is managed by a U.S. general partner (or the equivalent of a general partner) (GP) and (2) the foreign investor does not have any of the rights or access to any of the information described above in Question 1 (relating to "Other Transactions"). As described below, foreign investors may be given certain rights at the fund and investor level without creating an "Other Transaction."

While this carve-out may be workable for more established, traditional funds, a number of VC managers may find this carve-out limiting, including:

- Emerging managers that desire to provide investors with participation at the GP level (such as observer rights on the GP or manager's investment committee) or expanded information rights.

- Separately managed accounts (because they are direct investments, not indirect investments through an investment fund).
- Funds that permit investors to interact with portfolio companies, such as funds including (1) strategic investors or (2) linked to accelerators/incubators.

3. ***How do I determine if my fund is controlled by a "U.S. General Partner or Equivalent" for purposes of CFIUS and why is it important?***

The safe harbor described in Question 2 is available only for funds managed by a U.S. GP (or equivalent). CFIUS tends to review nationality of the GP from both a formal (*e.g.*, the jurisdiction of incorporation or organization of the GP) as well as a substantive perspective (*e.g.*, who controls the legal entity that is the GP).

CFIUS defines "control" extremely broadly as "the power, direct or indirect, whether exercised or not exercised, to determine, direct, or decide important matters affecting an entity" (although this definition is subject to regulations that may be promulgated by CFIUS in the future). This broad definition of "control" means that fund managers need to exercise care in structuring the GP and in allowing anchor investors or other limited partners control over certain or all aspects of the GP or its investment process, including potentially removal and/or replacement provisions of the GP or its key personnel (as described in Question 5 below).

4. ***How can I tell if an investor is "foreign" for CFIUS purposes?***

As with determination of nationality of the GP, determination of nationality of an investor involves both formal and substantive review. Just because funding may be provided through a U.S. entity does not make the investor automatically a U.S. investor. CFIUS retains authority to look at the nationality of investors to determine if they are "foreign" and thus "covered.

5. ***Can foreign investors be members of Advisory Committees and similar bodies (LPACs) without triggering CFIUS concerns?***

The 2018 CFIUS amendments permit foreign investors to be members of LPACs so long as (1) neither the LPAC nor the foreign investor has the right to approve, disapprove or otherwise exercise control over investment-related decisions of the fund or of the GP related to any investment, (2) the foreign investor does not have the right to approve or disapprove of appointment, removal or compensation of the GP and (3) the foreign investor cannot access material nonpublic technical information through the LPAC. A contractual right to waive conflicts of interest, concentration or other allocation limitations or similar activities, whether at the level of the LPAC or with respect to a specific foreign investor, will not violate these restrictions, except in extraordinary circumstances that may be specified by CFIUS. As part of the regulatory process, additional requirements and limitations on foreign investor involvement in LPACs may be established.

Compliance with limitations on foreign investor participation in the LPAC may be complicated in practice – *e.g.*, the foreign investor may have access to certain LPAC information and be able to participate in certain LPAC meetings, but not receive other information provided to the LPAC and attend other LPAC meetings. Care will thus be needed in structuring and running the LPAC.

6. ***Does it matter where my investors come from or what types of investors they are?***

If a fund complies with the safe harbor described in Question 2, the nationality of the fund's investors is irrelevant. For funds and/or structures that do not fit within this exemption, nationality of investors may be relevant. There are no country-specific prohibitions or barriers, although there are inferences that can be drawn as a result of separate provisions for information on investment by "entities of the People's Republic of China" and transactions that "would have allowed foreign persons to inappropriately influence democratic institutions and processes within the US and in other countries," a reference to Congressional interest in Russia.Conversely, other provisions in the Act suggest a Congressional intent to allow CFIUS to promulgate, by regulation, certain countries and/or types of investors (such as public pension funds) that will attract a lower degree of CFIUS scrutiny.

7. ***What information can I provide to non-U.S. investors without triggering CFIUS concerns?***

Foreign investors are specifically permitted to receive financial information, both at the fund level and with respect to specific fund investments. Information that foreign investors are specifically not permitted to receive – referred to as "material nonpublic technical information" – is broadly defined as information that (1) provides knowledge, know-how or understanding, not available in the public domain, of the design, location, or operation of critical infrastructure; or (2) 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.

A wide range of information will not be either financial information or material nonpublic technical information, such as business plans and product development roadmaps. In light of the current environment fund managers will need to consider carefully what information rights can be provided to foreign investors in a fund without creating an "Other Transaction" for CFIUS purposes.

Finally, because GP interaction with investors continues over the life of a fund, GPs will need to ensure that they have effective ongoing information control and compliance systems.

8. ***Will the 2018 CFIUS amendments affect co-investment structures?***

Indirect co-investment structures (as opposed to structures where investors invest directly in the underlying portfolio company) may be preferable under the 2018 CFIUS amendments, because the safe harbor described in Question 2 applies only where the investment is made through an investment fund. The exact determination may vary, however, in the light of the circumstances relevant to a particular transaction.

9. ***If a lot of details about the precise requirements and scope of the 2018 CFIUS amendments are left to formal rulemaking by CFIUS, what should I do now if I am structuring the fund and fundraising?***

Good question. The 2018 amendments contemplate that significant aspects relating to CFIUS will be determined through the regulatory process. For example, the Act specifies that CFIUS should "specify criteria to limit the application of [the CFIUS amendments] to the investments of certain categories of foreign persons." Further, in making this determination, these criteria should "take into consideration how a foreign person is connected to a foreign country or foreign government, and whether the connection may affect the national security of the United States." It is possible therefore, that certain types of foreign investors, such as certain public pension funds, may be excepted from the additional requirements imposed by CFIUS amendments. In addition, CFIUS is directed to provide guidance on what constitutes an "Other Transaction."

Because investment periods typically extend for a number of years, funds that are now in formation or already in operation may face a situation where they need to cutback rights previously granted to foreign investors to avoid having investments and "Other Transactions" subject to CFIUS review and approval. Although there are no guarantees, for funds now in formation, careful consideration of CFIUS issues in structuring the fund may reduce CFIUS-related risks.

10. ***Can CFIUS filings be required in connection with fund formation or only fund investments?***

Technically, CFIUS filings will not be required at the time of fund formation, assuming that the fund has not previously invested in a "U.S. business." If the fund does not come within the express carve-out described in Question 2, foreign investor participation in the fund may trigger CFIUS authority to review with respect to each relevant investment, change in the relevant investment or "Other Transaction" by the fund. To avoid these repetitive CFIUS obligations which may create ongoing impediments to fund investments and transactions, the fund manager may find it advantageous to make a CFIUS filing – referred to as a "declaration" with respect to the fund generally, so that (absent a specific requirement by CFIUS) additional CFIUS filings are not necessary in the context of specific investments and transactions.

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[1] Congress has identified certain factors that CFIUS "may consider" for countries "of special concern," including "cumulative control", a foreign person's "history of complying" with U.S. laws and regulations, control that affects the "capability and capacity" of the U.S. to meet national security requirements, potential exposure to "personally identifiable information" or sensitive citizen data, and whether a transaction could exacerbate or create "new cybersecurity vulnerabilities" or enable a foreign government to gain "significant new capability to engage in malicious cyber-enabled activities."

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Richard B. Holbrook Jr.
Partner – Washington, D.C.
Phone: +1 202.508.8779
Email: rholbrook@crowell.com

Robert Holleyman
Partner and C&M International President & CEO – Washington, D.C.
Phone: +1 202.624.2505
Email: rholleyman@crowell.com