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## Innovation Meets Regulation: FIRRMA's Significance, the Treasury's Dilemma, and the New Normal for Foreign Investment in the U.S. Venture Capital Ecosystem

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# **Innovation Meets Regulation: FIRRMA's Significance, the Treasury's Dilemma, and the New Normal for Foreign Investment in the U.S. Venture Capital Ecosystem**

## *Abstract*

*One of the most powerful entities in the federal government is the little-known Committee on Foreign Investment in the United States (CFIUS), which is responsible for reviewing foreign investment transactions with U.S. businesses for potential national security threats. Originally, CFIUS was only able to review foreign investments that resulted in control of the U.S. company at issue, but the Foreign Investment Risk Review Modernization Act (FIRRMA) has significantly enhanced CFIUS's scope to include review of minority investments.*

*This Comment explores FIRRMA's impact on foreign investment into the U.S. venture capital (VC) ecosystem and evaluates the uncertainty created for startups and venture capitalists (VCs) in the law's final rules enacted by the U.S. Department of the Treasury. Specifically, this Comment proposes potential solutions that could lessen the uncertainty for the VC community without hindering CFIUS's ability to protect national security. Finally, this Comment discusses one of the most significant policy debates of the twenty-first century, namely, the dilemma between remaining economically competitive by keeping capital markets relatively unrestricted and the equal importance of protecting national security. This Comment argues that while failing to lessen the uncertainty of the final rules may ultimately slow foreign investment into the U.S. VC ecosystem, this may be a necessary price to pay for closer monitoring of foreign investments coming from hostile foreign actors.*

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## I. INTRODUCTION

One moment a large and highly successful Singaporean chipmaker was on the brink of acquiring one of its major U.S. competitors, which would have been the largest technology merger in history, and the next moment the deal was blocked by the U.S. government before the parties could even attempt to finalize their agreement.<sup>1</sup> The government agency responsible for putting the brakes on the transaction, the Committee on Foreign Investment in the United States (CFIUS), reviews foreign transactions for potential national security issues.<sup>2</sup> Today, CFIUS operates as a referee, exercising its power to protect vital U.S. economic<sup>3</sup> and national security interests including, for example, ensuring that innovation in artificial intelligence does not fall into the hands of threatening foreign actors.<sup>4</sup> More specifically, CFIUS first reviews a

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1. See *CFIUS Intervenes in Broadcom's Attempt to Buy Qualcomm*, *ECONOMIST* (Mar. 8, 2018), <https://www.economist.com/business/2018/03/08/cfius-intervenes-in-broadcoms-attempt-to-buy-qualcomm>. Broadcom, the Singaporean chipmaker, attempted to buy Qualcomm, the U.S. chipmaker and innovator in 5G wireless technology, in a hostile takeover bid. *Id.* In a letter effectively blocking the transaction due to national security concerns, CFIUS noted that although it could not reveal its specific concerns because they were “classified,” it could not stomach Broadcom’s “relationships with third party foreign entities” potentially interacting with Qualcomm’s 5G wireless technological developments. Letter from Aimen N. Mir, Deputy Assistant Sec’y for Inv. Sec., U.S. Dep’t of Treasury, to Mark Plotkin, Covington and Burling LLP, and Theodore Kassinger, O’Melveny & Myers LLP, SEC (Mar. 5, 2018), [https://www.sec.gov/Archives/edgar/data/804328/000110465918015036/a18-7296\\_7ex99d1.htm](https://www.sec.gov/Archives/edgar/data/804328/000110465918015036/a18-7296_7ex99d1.htm). Most notably, Broadcom is not even a Chinese firm, but its potential third-party contacts with Chinese actors were enough to send the deal over a cliff. *Id.*; see also Mike Freeman, *Broadcom Completes Headquarters Move from Singapore to the U.S.*, *SAN DIEGO UNION-TRIB.* (Apr. 5, 2018, 3:05 PM), <https://www.sandiegouniontribune.com/business/technology/sd-fi-headquarters-broadcom-20180405-story.html> (explaining that Broadcom had started out as a U.S. company, was subsequently bought by a Singapore-based company, and then decided to redomicile in the U.S. after its Singapore location became a key factor in CFIUS’s recommendation to block Broadcom’s attempted acquisition of Qualcomm).

2. See Amy Deen Westbrook, *Securing the Nation or Entrenching the Board: The Evolution of CFIUS Review of Corporate Acquisitions*, 102 *MARQ. L. REV.* 643, 643 (2019). CFIUS, referred to as the “ultimate regulatory bazooka,” evaluates “mergers that could result in control of an American business by a foreign individual or company” and can “intervene and review pending or completed transactions” unilaterally. Kevin Granville, *Cfius, Powerful and Unseen, Is a Gatekeeper on Major Deals*, *N.Y. TIMES* (Mar. 5, 2018), <https://www.nytimes.com/2018/03/05/business/what-is-cfius.html>.

3. See JAMES K. JACKSON, *CONG. RESEARCH SERV.*, RL 33388, *THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) 19–20* (2020).

4. See Westbrook, *supra* note 2, at 665. In the past, CFIUS has exercised its authority to block foreign acquisitions by countries such as Japan, China, and the United Arab Emirates. *Id.* at 663, 665–66, 673.

“covered transaction”<sup>5</sup> that is “proposed, pending, or completed,”<sup>6</sup> investigates the transaction, and then submits its findings to the President of the United States for a determination of the transaction’s fate.<sup>7</sup> Formal CFIUS review can be triggered in a multitude of ways: unilaterally by the President or any member of CFIUS, voluntarily by one or both of the parties to the transaction, or through a mandatory filing process.<sup>8</sup>

Due to the current economic, technological, and geopolitical rise of China and the need to protect U.S. high technology companies from Chinese espionage, Congress passed the Foreign Investment Risk Review Modernization Act (FIRRMA), which was signed into law by President Trump on August 13, 2018.<sup>9</sup> Most significantly, FIRRMA enlarged CFIUS’s power to review foreign investments into U.S. companies for national security reasons.<sup>10</sup> Before FIRRMA, CFIUS would scrutinize foreign investments that resulted in foreign *control* of a U.S. company.<sup>11</sup> After FIRRMA, however, CFIUS now has broader authority to review and block transactions where only a *minority* investment is made in a U.S. company.<sup>12</sup> Despite Congress’s focus on China, CFIUS’s enhanced authority to block foreign transactions is not limited to Chinese entities, as evidenced by the blocking of Singaporean chipmaker Broadcom’s attempt to purchase Qualcomm.<sup>13</sup>

The expansion of CFIUS’s power to review minority investments in U.S. technology startups could have broad implications for venture capital (VC)

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5. See 50 U.S.C. § 4565 (2018).

6. *Id.*

7. See Westbrook, *supra* note 2, at 671.

8. *Id.* at 672, 681–82.

9. See Bobby Franklin, *A New Foreign Investment Bill Will Impact Venture Capital and the US Startup Ecosystem*, TECH CRUNCH (Aug. 17, 2018, 7:30 AM), <https://techcrunch.com/2018/08/17/a-new-foreign-investment-bill-will-impact-venture-capital-and-the-u-s-startup-ecosystem/>. It is important to note that according to the Department of Defense, “in 2015 Chinese investors put [between three and four billion dollars] into early-stage venture deals.” See *Silicon Valley Gets Queasy About Chinese Money*, ECONOMIST (Aug. 9, 2018), <https://www.economist.com/business/2018/08/09/silicon-valley-gets-queasy-about-chinese-money>. Further, from 2015 to 2017, China ranked second only behind Europe as the largest foreign source for capital for U.S. startups. *Id.*

10. See Franklin, *supra* note 9.

11. *Id.*; see Westbrook, *supra* note 2, at 668.

12. See Franklin, *supra* note 9. Under FIRRMA, CFIUS has the power to review and ultimately kill any transaction where, *inter alia*, a foreign investment in a U.S. company grants the investor access to confidential information relating to technical information, observer rights, membership on the company’s board of directors, or *any* involvement in the company’s substantive decisionmaking. *Id.*

13. See *CFIUS Intervenes in Broadcom’s Attempt to Buy Qualcomm*, *supra* note 1.

firms and the startup companies they invest in.<sup>14</sup> This is significant because startups backed by venture capitalists (VCs) are often at the forefront of technological innovation and play a key role in the strength and competitiveness of the U.S. economy.<sup>15</sup> Venture firms receive money from their limited partners (LPs) and subsequently invest that money into startups characterized by high upside growth potential.<sup>16</sup> In return for what is usually a minority investment in the startup, the VCs will ask for, among other things, a broad range of control rights such as a seat on the board of directors<sup>17</sup> and information rights.<sup>18</sup> The LPs who invest in VCs are often “foreign” persons who contribute billions in investment, which in turn is injected into the U.S. startup ecosystem.<sup>19</sup>

The VC community, led by the National Venture Capital Association (NVCA), fought hard to implement changes to FIRRMA before it was signed by President Trump.<sup>20</sup> For instance, based on the NVCA’s lobbying, FIRRMA’s drafters inserted an exception into the legislation for foreign LPs, stating that a CFIUS filing would not be triggered so long as the fund itself and its investment decisions were not subject to the foreign investor’s “control.”<sup>21</sup> The debate between the VC community and lawmakers during the legislative process represented the tension between protecting VC investment into critical infrastructure on the one hand and preventing foreign

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14. See Scott Kupor, *On CFIUS Reform: Examining the Essential Elements*, ANDREESSEN HOROWITZ (June 17, 2019), <https://a16z.com/2019/06/17/cfius-firrma-reform-policy-testimony-january-2018/>; Franklin, *supra* note 9.

15. See SCOTT KUPOR, *SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT 41* (2019).

16. *Id.* at 29.

17. *Id.* at 171–73.

18. *Id.* VC funds will often request “the right to obtain certain financial information, as well as inspection rights with respect to corporate records.” Mike Sullivan & Richard D. Harroch, *A Guide to Venture Capital Financings for Startups*, FORBES (Mar. 29, 2018, 11:00 AM), <https://www.forbes.com/sites/allbusiness/2018/03/29/a-guide-to-venture-capital-financings-for-startups/#6ab5c80051c9>.

19. See Kupor, *supra* note 14.

20. See Devin Miller, *NVCA Recommends Key Changes to CFIUS Rules that Impact Investment into U.S. Startups*, NAT’L VENTURE CAP. ASS’N, <https://nvca.org/pressreleases/nvca-recommends-key-changes-to-cfius-rules-that-impact-investment-into-u-s-startups/> (last visited Mar. 9, 2021). The NVCA lobbied for changes including, among other things, more clarity for the definition of “Foreign Person,” clarity for the definition of “Material Nonpublic Technical Information,” and narrowing the scope of “Sensitive Personal Data.” *Id.*

21. See *infra* note 177 and accompanying text.

industrial espionage on the other.<sup>22</sup> The final regulations implementing FIRRMA (the Final Rules), issued by the U.S. Department of the Treasury (the Treasury), represent an attempt to strike a balance between protecting national security and safeguarding foreign investment into America's most treasured and innovative companies.<sup>23</sup> Uncertainty remains for VCs and foreign investors, however, thus increasing transaction costs for existing deals and potentially driving away foreign investors.<sup>24</sup> This uncertain landscape is likely to become the new normal for foreign investment in the VC ecosystem for decades to come.<sup>25</sup>

This Comment analyzes how FIRRMA expands CFIUS's enforcement power and the impact that expansion will have on foreign investment in the VC ecosystem.<sup>26</sup> Part II recounts the history and significance of VC to the U.S. economy, focusing on how VC investment works, and the origins and importance of CFIUS.<sup>27</sup> Part III identifies the ways in which FIRRMA has drastically expanded CFIUS's power to review foreign minority investments into U.S. companies.<sup>28</sup> Part IV argues that FIRRMA's broad provisions leave U.S. startups, VCs, and foreign investors with higher transaction costs due to added uncertainty.<sup>29</sup> While thorough analysis of every major provision in FIRRMA is beyond the scope of this Comment, key uncertainties are discussed, such as how CFIUS could apply its definition of "control" in relation to the VC's limited and general partners, as well as how the standard for "material non-public technical information" is overinclusive so as to potentially discourage foreign investment.<sup>30</sup> Part IV also argues that this remaining uncertainty should not be surprising, as the Treasury has a strong interest in crafting broader rules to retain as much jurisdiction over foreign investment transactions as possible for national security reasons.<sup>31</sup> Part V demonstrates how FIRRMA has added uncertainty to the VC ecosystem and predicts how it will continue to add costs of ongoing compliance and

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22. See Miller, *supra* note 20.

23. See *infra* Section IV.B.

24. See *infra* Section IV.A.

25. See *infra* Section IV.B.

26. See *infra* Part IV.

27. See *infra* Part II.

28. See *infra* Part III.

29. See *infra* Part IV.

30. See *infra* Section IV.A.

31. See *infra* Section IV.B.

monitoring, unless the Treasury provides clearer guidance regarding certain provisions that might trigger CFIUS jurisdiction, including material nonpublic technical information and sensitive personal data.<sup>32</sup> Finally, Part VI concludes by noting that while it is important for the Treasury to fix uncertainties with the Final Rules where it can go forward, VCs, high-tech startups in the U.S., and foreign investors must remain vigilant in complying with FIRRMA's provisions for the foreseeable future.<sup>33</sup>

## II. THE STORY OF VENTURE CAPITAL AND FOREIGN INVESTMENT'S GATEKEEPER

Venture capital, which has led to tremendous economic growth, innovation, invention, and prosperity for the U.S., is woven through the fabric of our nation's history.<sup>34</sup> As globalization has taken hold around the world, however, issues of national security have come to clash with the free flow of capital.<sup>35</sup>

### A. *Venture Capital: Origins and Importance*

Venture capital refers to the financing of emerging growth startups, which are entities characterized by high risk and return.<sup>36</sup> Most venture-backed startups will fail, but the ones that succeed yield exceptional payoffs.<sup>37</sup> The venture capitalist (or the VC firm) serves as an intermediary between the investors, who provide funding, and the entrepreneurs, who use the investors' funding to undertake the business endeavor and see it to fruition.<sup>38</sup> Silicon Valley is the epicenter for such financing today, but it is not where the story of VC began in the U.S.<sup>39</sup>

In the eighteenth and nineteenth centuries, the U.S. dominated commercialized whaling ventures.<sup>40</sup> These ventures involved a whaling agent

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32. *See infra* Part V.

33. *See infra* Part VI.

34. *See infra* Section II.A.

35. *See infra* Section IV.B.

36. *See* KUPOR, *supra* note 15, at 26–27.

37. *Id.* at 31.

38. TOM NICHOLAS, VC: AN AMERICAN HISTORY 2 (2019).

39. *Id.* at 3–4.

40. *Id.* at 11–12, 16.



who acted as an intermediary between wealthy investors and the captain and crew involved in undertaking the voyage.<sup>41</sup> The objective of the journey was to pursue whales for their whalebone, whale oil, and sperm oil; this practice was enormously lucrative but very risky, as failure was far more common than success.<sup>42</sup> Furthermore, the whaling ventures of two centuries ago were characterized by investors who gave their capital to more knowledgeable whaling agents and a payment structure that aligned the incentives of each party based on the amount of risk inherent in whaling ventures.<sup>43</sup> The whaling agent had to choose the right captain and crew for the best chance of success, and “past success had a sizeable impact on the probability of future success, as is also the case in entrepreneurial performance in modern VC-backed enterprises.”<sup>44</sup> Overall, the high risk of failure, the intermediary organizational structure, and the payment incentives from the whaling industry were precursors to the modern form of VC investing that is predominant today.<sup>45</sup>

The whaling industry dwindled going into the mid-nineteenth century, but the deployment of risk capital to entrepreneurial ventures continued to advance.<sup>46</sup> In particular, cotton textile production during the nineteenth century involved wealthy investors financing entrepreneurs who had the human capital necessary to innovate cotton machinery.<sup>47</sup> For example, Francis Cabot Lowell created the Boston Manufacturing Company, which was a corporate intermediary between investors (shareholders) who funded innovative cotton textile mills, and the entrepreneurs who put their human capital to work to build those mills.<sup>48</sup> Similar financial intermediaries

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41. *Id.* at 11.

42. *Id.* at 13–16. By the mid-nineteenth century, American whaling voyages took roughly 3.6 years to complete, were often exceedingly dangerous, and often were unsuccessful, as evidenced by the high rates of voyages returning home with little to no oil—if they returned home at all. *Id.* at 16–19.

43. *Id.* at 21. For example, the whaling agent was typically paid a fee for his services in organizing the voyage and hiring the crew. *Id.* Captains and crews received ownership stakes upon the success of the voyage to compensate them for the low likelihood of success (similar to modern VC-backed startups, where officers are granted equity incentives to compensate them for taking on substantial risk of failure). *Id.* at 21, 33.

44. *Id.* at 31. Interestingly, failure “as a whale captain brought all the stigma of modern-day entrepreneurial failure.” *Id.* at 18.

45. *Id.* at 21, 31.

46. *Id.* at 40–41.

47. *Id.* at 41.

48. *Id.* at 53, 55. By 1853, Lowell Massachusetts (named after Francis Cabot Lowell) was one of

financed the railroad expansion in the U.S., allowing for billions of dollars of capital from the U.S. and overseas to finance the building of thousands of miles of tracks, ushering in the second industrial revolution.<sup>49</sup> Further, financiers like John Pierpont Morgan helped to facilitate the development of electricity by funding Thomas Edison's labs, ultimately transforming American productivity due to electricity's scale and wide range of uses, both commercial and noncommercial.<sup>50</sup>

The practice of wealthy investors directly financing innovative entrepreneurs and creating intermediary entities to finance groundbreaking ideas continued into the twentieth century.<sup>51</sup> In particular, the provision of venture finance into high-tech startups through the family offices<sup>52</sup> of wealthy investors as well as partnership and corporate entities<sup>53</sup> closely resembled modern VC investment.<sup>54</sup> For example, the family office of oil tycoon John D. Rockefeller was used by his grandson, Laurance Rockefeller, to invest in emerging high-tech startups before and after the Second World War.<sup>55</sup> Before the war, Rockefeller provided the initial capital to James McDonnell, Jr.,

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the most important industrial innovation clusters in the U.S., with "thirty-five cotton mills employing over ten thousand workers" and backed by millions of dollars of capital. *Id.* at 55.

49. *Id.* at 57.

50. *Id.* at 58–59. The story of wealthy investors funneling their capital to risk takers with promising ideas has fueled American productivity and innovation for centuries. *Id.* For example, investor and industrialist Andrew Mellon helped fund innovations relating to aluminum production, silicon carbide, and oil exploration by finding top entrepreneurs, taking an equity stake in their companies, and providing management and organizational expertise. *Id.* at 64–66. Photography pioneer George Eastman partnered with and received funding from wealthy investor Henry Strong, ultimately leading to the famous Eastman Kodak company and its revolutionary camera. *Id.* at 81. Henry Ford's immense success was due in large part to investor Alexander Malcomson, who raised capital and helped coordinate the management of the Ford Motor Company as a shareholder, leading to innovations in the assembly line and the proliferation of the Model T. *Id.* at 82. Finally, the provision of capital, managerial oversight, and patent protection to inventor Philo Farnsworth during the 1920s led to the emergence of television. *Id.* at 85.

51. *Id.* at 79–80.

52. See Adam Hayes, *Family Offices*, INVESTOPEDIA (April 19, 2020), <https://www.investopedia.com/terms/f/family-offices.asp>. Family offices are private wealth management firms devoted to investing on behalf of one or several ultra-high net worth investors. *Id.*

53. See NICHOLAS, *supra* note 38, at 100–02. For example, J.H. Whitney & Company was founded in 1946 as a limited partnership and invested in startup ventures such as Minute Maid by buying preferred stock, targeting scalable ventures, cultivating management teams, and exercising a reasonable amount of control over the firms. *Id.*

54. *Id.* at 79.

55. *Id.* at 91–92. Specifically, "[i]n 1946, Laurance and his siblings established a private-capital arm of the family office called Rockefeller Brothers, Inc., to pool their capital with a focus on venture investments." *Id.* at 93.

whose expertise in jet propulsion would lead to the development of top fighter aircrafts used during World War II.<sup>56</sup> After the war, Rockefeller provided startup capital to the founder of Itek Corporation, who developed sophisticated camera reconnaissance for the U-2 spy plane of the Cold War era.<sup>57</sup> Similar to modern VC investing, Rockefeller targeted a particular market (aviation), sought high-growth and scalable ventures, and required highly competent management.<sup>58</sup> Ultimately, however, the investments of individual investors, family offices, and private corporate entities could not achieve the performance of modern VC firms.<sup>59</sup>

The beginning of modern VC investing began after World War II amidst the backdrop of substantial research and development spending by the U.S. government.<sup>60</sup> The war created a shortage in startup capital due in part to excessively high personal income taxes.<sup>61</sup> In response to this opportunity and gap in funding, prominent members of academia and finance in New England incorporated<sup>62</sup> the American Research and Development Corporation (ARD) in 1946.<sup>63</sup> Whereas VC funding into entrepreneurial startups had previously been fueled by private family wealth, ARD's business model was to acquire capital primarily from institutional investors<sup>64</sup> to invest in promising

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56. *Id.* at 92.

57. *Id.* at 95.

58. *Id.* at 94. Similar to the low success rate of venture investments, Laurance Rockefeller's investments in the aggregate underperformed the overall market between 1938 and 1969, with "[a]round 44 percent of his investments fail[ing] to produce positive returns." *Id.* at 95–96.

59. *Id.* at 106.

60. *Id.*

61. *Id.* at 110. In 1936, under President Franklin Delano Roosevelt's New Deal tax reforms, "the top federal tax rate on regular income was 79 percent and the rate on capital gains reached 39 percent." *Id.* Many commentators argued that the New Deal taxes stifled investment into early-stage startups because no wealthy individuals would assume such risk. *Id.*

62. *Id.* at 117–18. The American Research and Development Corporation was incorporated rather than made a limited partnership (the most common entity for venture capital firms today) because it treated its institutional shareholders as business partners, whereas in a limited partnership, control over the investment decisions is vested in certain general partners. *Id.* at 118.

63. *Id.* at 117. A further impetus for the formation of ARD was that "about 45 percent of New England wealth was held by institutions like trust and insurance companies" and could be tapped into by a financial intermediary for investment in early-stage startups. *Id.* at 115.

64. These institutional investors largely consisted of trust and insurance companies, and because of their fiduciary and specialized nature, state regulations forced them to engage in conservative investment strategies. *Id.* Further, they did not have the expertise to directly invest in growth-oriented startups regardless, necessitating the need for a vehicle like ARD to allow them to tap into riskier assets such as emerging-growth ventures. *Id.*

ventures.<sup>65</sup> ARD's investment approach centered on rigorously screening potential investments, finding talented and capable founders, engaging in managerial oversight by obtaining a seat on the portfolio company's board, providing incentives for founders to remain actively engaged in the venture, and staging its investments to avoid risk.<sup>66</sup> This investment strategy was a precursor to modern VC and led to the highly successful investment in Digital Equipment Corporation (DEC), which became the first company to mass-produce minicomputers.<sup>67</sup> The *ex-ante* risk of investing in DEC was substantial, as IBM was a major competitor in computing, but ARD's initial \$70,000 investment in 1957 turned into an incredible \$355 million by 1971.<sup>68</sup> As a testament to the power of successful VC investments to affect regional growth, "DEC became the largest employer in Massachusetts, and America's second largest computer manufacturer behind IBM."<sup>69</sup> ARD's investment in DEC became a catalyst and an inspiration for future venture capitalists, demonstrating that an investment model centered on deploying capital and managerial expertise to risky, growth-oriented startups could pay off exponentially.<sup>70</sup>

While ARD's investment model and success proved that these VC investments could be profitable, its incorporation as a closed-end fund<sup>71</sup> was less advantageous for a variety of reasons.<sup>72</sup> Between 1950 and 1970, the limited partnership became the preferred entity for venture capitalists.<sup>73</sup> The

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65. *Id.* at 116–17.

66. *Id.* at 126.

67. *Id.* at 128.

68. *Id.* at 128–30. This monumental payoff for ARD closely resembles modern VC returns, and the risk assumed by ARD in betting on a fledgling startup in an industry with powerful incumbent competitors also mirrors the large amount of risk VC entails. *Id.*; see also Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., <https://hbr.org/1998/11/how-venture-capital-works> (last visited Mar. 9, 2021) (explaining that the VC's "challenge is to earn a consistently superior return on investments in inherently risky business ventures.").

69. NICHOLAS, *supra* note 38, at 129.

70. *Id.* at 143.

71. See Jeff Brown, *Pros and Cons of Closed-End Funds*, U.S. NEWS (Sept. 7, 2016, 10:02 AM), <https://money.usnews.com/investing/articles/2016-09-07/pros-and-cons-of-closed-end-funds>. A closed-end fund is an investment vehicle that "produces a finite number of shares" at its inception, meaning that "no new shares are created when an investor purchases them." *Id.* This structure can make investors more susceptible to illiquidity and volatility issues. *Id.*

72. NICHOLAS, *supra* note 38, at 143. An analysis of the closed-end fund structure and its costs and benefits is beyond the scope of this Comment. *Id.*

73. *Id.* at 144–45.

intermediary structure between capital providers and entrepreneurial ventures remained, with the capital providers serving as LPs and receiving limited liability protection.<sup>74</sup> The investment managers of the venture fund who would direct and oversee the individual investments served as general partners in the limited partnership.<sup>75</sup> The widespread adoption of the limited partnership was due in part to the ability of general partners to have an increase in their partnership interest taxed as capital gain, and thus at a lower rate than the personal income rate.<sup>76</sup> Further, in the mid-1970s, the federal government gave “pension funds greater latitude to invest in alternative areas, including venture capital,” which increased the total capital available for venture funds to attract.<sup>77</sup> Finally, the limited partnership structure was bolstered as a result of a movement to lower the capital gains tax rate in 1978.<sup>78</sup> This policy shift benefited general partners who received part of their compensation via carried interest,<sup>79</sup> which was “subject to capital gains taxation and not to ordinary income taxation.”<sup>80</sup> A lower capital gains tax rate also acted to incentivize potential entrepreneurs to take the risk of starting their own ventures, as the lower taxes compensated for the added risk of entrepreneurial failure.<sup>81</sup> One notable venture firm organized as a limited partnership in 1969, Venrock Associates, became a first-round investor in Intel and participated in multiple rounds of funding in Apple Computer.<sup>82</sup>

Modern VC firms are most closely connected to Silicon Valley.<sup>83</sup> This innovation cluster’s meteoric rise was made possible in part due to the human capital of Stanford University, as well as government military expenditures over the course of decades.<sup>84</sup> Stanford’s Industrial Park—which sought to

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74. *Id.* at 150–51.

75. *Id.* at 148–49.

76. *Id.* at 153.

77. *Id.* at 173–77.

78. *Id.* at 179.

79. *Id.* at 152 (explaining that “[t]he principle of carried interest is fundamental to modern venture capital—indeed, it dominates how the industry is structured”). See also Roger Wohlner, *What Is Carried Interest and How Does It Work?*, STREET (Aug. 21, 2019, 10:45 AM), <https://www.thestreet.com/investing/funds/what-is-carried-interest-15062756> (explaining that carried interest is the management fee paid to investment funds’ general partners, usually represented as 2% of assets annually).

80. NICHOLAS, *supra* note 38, at 177.

81. *Id.* at 177.

82. *Id.* at 170.

83. *Id.* at 183.

84. *Id.* at 184.

provide resources and office space for high-tech companies—attracted companies like General Electric, Hewlett-Packard, and Eastman Kodak, employing thousands of people during the 1960s.<sup>85</sup> The U.S. government also played an instrumental role in financing and developing innovative technologies due to military procurement during World War II, the Korean War, and the Cold War.<sup>86</sup> Military demand for high-tech products led to continuous firm creation in Silicon Valley as well as a sharp increase in human capital and high-tech sector employment.<sup>87</sup> Silicon Valley’s preeminence in VC investment and innovation continues to this day, with the West Coast accounting for 38.2% of deal count and 57.8% of deal value in the third quarter of 2019.<sup>88</sup>

### B. *The Modern Venture Capital System*

The history of VC in the U.S. illustrates its cultivation of invention and entrepreneurship, and its importance to the development of the overall economy.<sup>89</sup> Understanding how the VC industry may be affected by FIRRMA, however, requires a more in-depth understanding of the function and organization of VC firms and their investors.<sup>90</sup> VC finances “companies (whether technology based or not) that are not otherwise good candidates to

85. *Id.* at 185. The impact of educational institutions like Stanford, UC Berkeley, and San Jose State University “meant that capital, expertise, and ideas were attracted to the region, creating a cluster of economic activity and an excess of potential venture-based opportunities.” *Id.* at 186–87.

86. *Id.* at 187. Silicon Valley entrepreneurs greatly benefitted from government research grants and procurement contracts, which funded fledgling products such as semiconductors. See April Dembosky, *Silicon Valley Rooted in Backing from US Military*, FIN. TIMES (June 9, 2013), <https://www.ft.com/content/8c0152d2-d0f2-11e2-be7b-00144feab7de>. Today, In-Q-Tel, a non-profit formed by the Central Intelligence Agency to fund intelligence technology, backs dozens of Silicon Valley startups in areas such as software analytics and big data. *Id.*

87. NICHOLAS, *supra* note 38, at 188–89.

88. See 2019 Pitchbook—NVCA Venture Monitor, 3Q PITCHBOOK 1, 16 (2019).

89. See *supra* Section II.A. Regarding the impact on the U.S. economy, VCs invest an infinitesimally small amount of money in businesses—as compared with their counterparts in the financial services industry—but help to fund businesses at the forefront of technological innovation. See Will Gornall & Ilya A. Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies* (Stanford Univ. Graduate Sch. of Bus. Rsch., Working Paper No. 3362, 2015). Further, since 1974, “42 percent of public companies [have been] venture[-]backed, representing 63 percent of total market capitalization” in the U.S. and “account[ing] for 35 percent of total employment and 85 percent of total research and development spend.” KUPOR, *supra* note 15, at 41. Notable examples of venture-backed companies include Microsoft, Apple, Facebook, Amazon, and Google. *Id.*

90. See KUPOR, *supra* note 15, at 26; Zider, *supra* note 68.

get funding from other, more traditional financial institutions.”<sup>91</sup> Further, VC funding targets new businesses, or startups, as opposed to already established businesses.<sup>92</sup> These early-stage businesses typically require five to eight years to become mature ventures.<sup>93</sup> Startups receive cash from VCs in exchange for *equity*, which is shares of the company’s stock corresponding to an ownership stake in the business.<sup>94</sup> Further, the venture capitalist not only invests money in the startup but also “invest[s] [its] own expertise, managerial skills, time and connections in nurturing [the] company into profitability.”<sup>95</sup> In exchange for taking on the risk of investing at such an early stage—in that the startup is not making a profit, there are no financial metrics to value the company, and the investors have to wait years before their investment actually pays off—the

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91. KUPOR, *supra* note 15, at 26. The more traditional source of funding for most new businesses comes in the form of small business loans or debt, as opposed to equity investments, from banks. *Id.* The startup must decide whether or not it can generate enough cash-flow in the short-term “to pay interest (and ultimately principal) on debt.” *Id.* at 27. If it decides that it can, then it might opt for debt financing; however, if it decides that it may not be able to come up with the steady stream of cash until later down the road, it may decide to opt for equity financing by electing the venture capital route. *Id.*

92. See Barbara Friedberg, *How to Invest in Venture Capital*, U.S. NEWS (Sept. 11, 2019, 2:56 PM), <https://money.usnews.com/investing/investing-101/articles/how-to-invest-in-venture-capital>.

93. See *What Is Venture Capital?*, NAT’L VENTURE CAP. ASS’N, <https://nvca.org/about-us/what-is-vc/> (last visited Mar. 9, 2021).

94. See Caroline Banton, *Equity Financing*, INVESTOPEDIA (July 1, 2020), <https://www.investopedia.com/terms/e/equityfinancing.asp> (explaining that “[e]quity financing is the process of raising capital through the sale of shares”). Further, startups are more prone to opt for equity financing over more traditional debt financing from a bank because

[such financing] is often the better choice for businesses that (1) are not generating (or expecting to generate) near-term cash flow; (2) are very risky (banks don’t like to lend to businesses where there is real risk of the business failing, because they don’t like losing the principal balance of their loans); and (3) have long illiquidity periods (again, banks structure their loans to be time limited—often three to five years in length—to increase the likelihood of getting their principal back).

KUPOR, *supra* note 15, at 28.

95. David Rosenberg, *The Two Cycles of Venture Capital*, 28 J. CORP. L. 419, 419 (2003). For example:

A venture capitalist’s competitive advantage is the expertise and guidance they provide to the entrepreneurs in their portfolio. Once the investment into a company has been made, venture capital partners actively engage with a company, providing strategic and operational guidance, connecting entrepreneurs with investors and customers, taking a board seat at the company, and hiring employees.

*What Is Venture Capital?*, *supra* note 93.

venture capitalist will ask for stock that has preferred economic<sup>96</sup> and control<sup>97</sup> rights relative to other common stockholders.<sup>98</sup>

The VC investment process can generally be characterized by four steps: (1) an institutional investor who serves as an LP invests in the VC's fund; (2) one or more general partners (GPs) who manage the VC firm then take that money and invest it in startups characterized by high upside growth potential; (3) the startup uses that money to grow;<sup>99</sup> and (4) the startup exits the VC ecosystem through either an initial public offering, merger or acquisition, or bankruptcy.<sup>100</sup>

LPs are institutional or wealthy individual investors with limited roles in the management and decisionmaking of the fund's investment choices.<sup>101</sup> Therefore, LPs are generally "passive investors" who "are along for the ride on which the venture fund decides to embark."<sup>102</sup> LPs invest in the funds of VC firms in the hopes of gaining well-above-market returns, usually measured relative to a standard benchmark such as the S&P 500.<sup>103</sup> Types of LPs

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96. Regarding economic preferences, VCs will negotiate for a host of benefits such as: (1) forcing all debt investments to convert into equity in order to ensure that debt investors are not paid before the venture capitalist upon liquidation; (2) ensuring that a future employee option plan be included in the post-money valuation; (3) including a liquidation preference, which says that upon some liquidation event (such as a sale of the company or a winding down), the venture capitalist gets paid first; (4) converting its preferred stock into common stock upon the company's IPO; and (5) including antidilution protection, which acts to lower the price per share of the stock the venture capitalist holds in the event of a subsequent round of financing yielding a lower valuation than the previous round. See KUPOR, *supra* note 15, at 142–66.

97. *Id.* at 170–88. As to preferences relating to control of the business, VCs will often require provisions such as: (1) requiring that for a certain period after the term sheet is signed the startup may not disclose the deal with other VCs; (2) requiring that the venture capitalist holds a seat on the company's board of directors; (3) protective provisions requiring a vote of a majority of the preferred stock on large matters relating to authorization of new classes of stock, liquidation, and increasing the company's employee stock option plan; (4) the right to participate in subsequent rounds of funding to maintain its stake in the company; (5) restrictions on the transfer of shares by the founders and other shareholders through rights of first refusal and co-sale rights; and (6) vesting provisions, which give the company a repurchase right, to decrease over time as the founder(s) continue their employment with the startup, as to the founder(s) shares. See *id.*

98. *Id.* at 141, 153.

99. *Id.* at 29.

100. *Id.* at 2.

101. *Id.* at 70.

102. *Id.*

103. *Id.* at 54. The S&P 500 "is a market-capitalization-weighted index of 500 of the largest U.S. publicly traded companies . . . [and] is widely regarded as the best gauge of large-cap U.S. equities." See Will Kenton, *S&P 500 Index—Standard & Poor's 500 Index*, INVESTOPEDIA (Dec. 22, 2020), <https://www.investopedia.com/terms/s/sp500.asp>.



include university endowments, foundations, pension funds, family offices, sovereign wealth funds, and insurance companies.<sup>104</sup> Because LPs are restricted as to the governance of the VC firm and its investment decisions, LPs are protected by limited liability if the VC firm is sued.<sup>105</sup> The legal relationship between the LPs and GPs of a VC firm is managed by the Limited Partnership Agreement (LPA).<sup>106</sup> For example, the LPA gives LPs the power to define and restrict the investment areas of the GPs of the VC firm, limit the personal investment activity of the GPs, and proscribes ways to exit the partnership under certain circumstances.<sup>107</sup>

Once the LPs have infused their capital into the VC's fund, the startup founders will pitch their ideas to the GPs, who will evaluate qualitative measures involving the potential startup's team, product or service, and the market the business hopes to enter.<sup>108</sup> VCs will heavily scrutinize the founders before investing due to the gravity of choosing people with exceptional leadership capabilities and creative problem-solving skills.<sup>109</sup> Further, VCs will evaluate whether the product or service will solve a fundamental need in the marketplace.<sup>110</sup> Finally, the market size must be sufficiently large in order for the business to bring in enough revenue to give VCs the return on investment they require.<sup>111</sup> After the founders' pitch and the VCs' rigorous due diligence, the VCs will take the capital invested by the LPs and invest it into the chosen startup.<sup>112</sup>

Once VCs invest in a particular startup, they take an active role in the

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104. KUPOR, *supra* note 15, at 54–56.

105. *Id.* at 70.

106. *Id.* at 85. Most LPAs limit information sent to the LPs to specific economic information such as quarterly financial reports of the investment fund's performance. *See* Kupor, *supra* note 14. Further, "most LPAs have an express provision in them in which LPs acknowledge that GPs may have independent fiduciary duties to their companies such that they may be restricted in their ability to share any information with LPs." *Id.*

107. KUPOR, *supra* note 15, at 85–88.

108. *Id.* at 43.

109. *See id.* at 43–44.

110. *Id.* at 48–50. This can be an in-depth evaluation of "the founder's idea maze: How did she get to the current product idea, incorporating which insights and market data to help inform her opinions?" *Id.* at 49. Further, the product must not be a mere marginal improvement of an existing product; it must be an innovation that is exceedingly less expensive and more effective than its predecessor in the same market. *Id.*

111. *Id.* at 50–52.

112. *Id.* at 29.

management and growth of the business.<sup>113</sup> For example, aside from engaging in governance oversight by sitting on the startup's board, the VC firm allocates its time to assist the startup with soliciting business, acting as a consultant, recruiting talented officers and employees, and cultivating outside relationships.<sup>114</sup> After multiple successful financing rounds and years of market expansion, the venture capitalist assists the startup in an acquisition or an initial public offering (IPO).<sup>115</sup> If an acquisition is contemplated, the venture capitalist may assist in ensuring the board conducts its proper legal responsibilities<sup>116</sup> and that a smooth transition is achieved.<sup>117</sup> If an IPO is the chosen exit strategy, the founders and the venture capitalist work together to choose the best investment bank to underwrite the shares, draft the prospectus, and market the shares to potential institutional investors.<sup>118</sup> This process of siphoning capital from LPs and into innovative companies has led to some of the greatest inventions in human history, and increasing globalization has led to greater amounts of VC investment coming into the U.S. from overseas.<sup>119</sup>

### C. *Foreign Investment into the U.S. Venture Capital Ecosystem*

Due to globalization and the emergence of influential foreign economies such as China, foreign investment in VC firms and startups serves as an important source of capital for the U.S. VC industry today.<sup>120</sup> In 2019, U.S. venture firms accounted for roughly 54% of global VC dollars spent, down from a high of 90% in 1990.<sup>121</sup> This dramatic decrease over the past thirty years bolstered calls for the U.S. VC industry to remain attractive to foreign

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113. See Zider, *supra* note 68.

114. *Id.*

115. See KUPOR, *supra* note 15, at 249. More than 80% of VC exits today are by acquisition rather than IPO, partially due to the fact that more money than ever before can be raised in the private capital markets. *Id.*

116. *Id.* at 254.

117. *Id.* at 256–57.

118. *Id.* at 260–63.

119. See *infra* Section II.C.

120. See *How Immigrant Entrepreneurs Pave the Way for Foreign VC Investments*, WHARTON: U. PA. (Oct. 29, 2019), <https://knowledge.wharton.upenn.edu/article/immigrant-entrepreneurs-pave-the-way-for-foreign-vc-investments/> (noting that “the globalization of capital to fund startups allows both investors and entrepreneurs to find each other better than before”).

121. See Kupor, *supra* note 14. While the global share of U.S. VC dollars spent has decreased, the current U.S. VC industry as of Q3 2019 raised \$29.6 billion and appeared to be on track to pass the \$40 billion mark by the end of Q4. See *2019 Pitchbook*, *supra* note 88, at 16.

investors amidst heightened foreign investment scrutiny by CFIUS under FIRRMA.<sup>122</sup> The NVCA has explained:

It is critical that passive foreign investment into U.S. venture funds be protected as the final rules under FIRRMA are developed. In recent years, foreign investors have increasingly invested into venture capital firms to gain exposure to the next wave of scientific and technological advancement. Passive foreign investment is vital to American startups as they grow, innovate, and create jobs . . . .<sup>123</sup>

It is difficult to quantify both the total amount of foreign investment into U.S. VC firms and direct foreign investment into U.S. startups.<sup>124</sup> This difficulty is because LPs, VC firms, and privately held startups are usually not required to disclose their investments.<sup>125</sup> Therefore, it is even more difficult to track the proportion of total foreign investment dollars into VC firms and startups coming from countries engaged in industrial espionage.<sup>126</sup> However, in 2017, only 3.2% of all U.S. VC deals, which amounted to \$9.3 billion in value, had one or more Chinese investors.<sup>127</sup> Thus, while Chinese entities are

122. See Kupor, *supra* note 14.

123. *Foreign Investment*, NAT'L VENTURE CAP. ASS'N, <https://nvca.org/foreign-investment/> (last visited Mar. 9, 2021).

124. See Kupor, *supra* note 14.

125. *Id.*

126. *Id.* According to estimates from Rhodium Group, an economic research firm, “Chinese entities have poured about \$14 billion into U.S. startups since 2000, with 80 percent of the deals occurring since 2014.” See Heather Somerville, *Chinese Investment in U.S Startups Peaks but ‘Tremendous Uncertainty’ Ahead*, REUTERS (May 7, 2019, 9:10 PM), <https://www.reuters.com/article/us-china-us-venture/chinese-investment-in-u-s-startups-peaks-but-tremendous-uncertainty-ahead-idUSKCN1SE0AF>; see also Savannah Dowling, *How One China-Based VC, Backed by the Government, Invests at Home and Abroad*, CRUNCHBASE (Dec. 17, 2017), <https://news.crunchbase.com/news/one-china-based-vc-backed-government-invests-home-abroad/> (noting that Shenzhen Capital Group, a prominent Chinese government-backed VC group, “participated in a late stage round for the U.S.-based 3D printing company, Desktop Metal”).

127. See Kupor, *supra* note 14. “U.S. venture-backed startups raised \$84 billion across 8,076 transactions.” *Id.* It is important to note that while FIRRMA’s underlying goal is to enable CFIUS to patrol foreign investments into U.S. companies by LPs connected to Chinese state actors, the evidence from 2017 indicates that investment from Chinese LPs is extremely small in proportion to the total investment in U.S. venture-backed startups. *Id.* Further, in 2016, 282 transactions into venture-backed startups had at least one Chinese entity, versus 8,635 transactions which had none. *Id.* In 2015, 305 transactions had at least one Chinese entity but 10,463 did not. *Id.* But cf. Theodore Schleifer, *Silicon Valley Is Awash in Chinese and Saudi Cash—and No One Is Paying Attention (Except Trump)*, VOX: RECODE (May 1, 2019, 5:00 AM), <https://www.vox.com/recode/2019/5/1/18511540/silicon-valley-foreign-money-china-saudi-arabia-cfius-firma-geopolitics-venture-capital> (explaining that Chinese

investing as LPs, the relatively small amount of money invested may strengthen the need for FIRRMA's final rules to avoid ambiguity as much as possible to avoid harming foreign LPs from other, less hostile nations, who might be less inclined to steal valuable intellectual property.<sup>128</sup> Policymakers have an incentive to draft CFIUS regulations that balance protecting sensitive high-tech information while simultaneously preserving the competitiveness of the U.S. VC industry.<sup>129</sup> China, for example, "has amassed [\$1.8 trillion] of state money across thousands of venture capital funds to achieve its goal of technological dominance by 2025."<sup>130</sup> Further, China "is now the second largest destination in the world for venture capital."<sup>131</sup> This rival competitiveness in high-tech innovation could mean greater regulation in the U.S., which would likely divert foreign capital away from the U.S. and toward China.<sup>132</sup> Therefore, ensuring competitiveness in high-tech by not discriminating against innocent foreign LPs while also protecting against harmful industrial espionage could prove to be one of the most challenging U.S. policy dilemmas of the 2020s.<sup>133</sup>

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influence and capital deployment in Silicon Valley has been meaningful).

128. See Kupor, *supra* note 14. For example, because of FIRRMA's current uncertainty, "Chinese investors, including big family offices, have walked away from transactions and stopped taking meetings with U.S. startups." See Somerville, *supra* note 126.

129. See Kupor, *supra* note 14.

130. See Emily Feng, *China's State-Owned Venture Capital Funds Battle to Make an Impact*, FIN. TIMES (Dec. 23, 2018), <https://www.ft.com/content/4fa2caaa-f9f0-11e8-af46-2022a0b02a6c>. The Federal Reserve Bank of Minneapolis estimates that "as of 2010, more than half of all technology owned by Chinese firms was obtained from foreign firms," illustrating the challenging task for Treasury regulators in crafting regulations that keep American VC competitive while guarding against industrial espionage. See Thomas J. Holmes et al., *The Costs of Quid Pro Quo*, FED. RES. BANK MINNEAPOLIS (Jan. 29, 2015), <https://www.minneapolisfed.org/article/2015/the-costs-of-quid-pro-quo>.

131. See Kupor, *supra* note 14; see also *China Became Second Largest Venture Capital Market by Total Capital Invested in 2018*, PITCHBOOK (Mar. 19, 2019), <https://pitchbook.com/media/press-releases/china-became-second-largest-venture-capital-market-by-total-capital-invested-in-2018-according-to-pitchbook-report> (highlighting that "[g]lobal investors [poured] increasing amounts of capital into China's startup ecosystem, with 29.4% of global VC directed into Chinese startups in 2018").

132. See Kupor, *supra* note 14.

133. See *id.* On the one hand, Chinese actors with ties to the government engage in intellectual property theft to the point where the FBI has met with investors in Silicon Valley to warn them of the dangers of their startups taking Chinese capital. See Schleifer, *supra* note 127. On the other hand, founders and investors are increasingly avoiding Chinese-linked LPs altogether due to FIRRMA, and "as many as a dozen China-linked firms have scaled back their US investment programs, some dramatically." *Id.*

*D. The Gatekeeper: CFIUS and Protecting American National Security*

CFIUS is an interagency committee within the Treasury, which serves at the pleasure of the President of the United States.<sup>134</sup> Created in 1975 by an Executive Order of President Gerald Ford, CFIUS arose out of congressional fear of politically-motivated foreign investment by Organization of the Petroleum Exporting Countries (OPEC) and was an attempt by the executive branch to “‘dissuade Congress from enacting new restrictions’ on foreign investment.”<sup>135</sup> The Committee’s initial mandate was to “[monitor] the impact of foreign investment in the United States, both direct and portfolio, and [coordinate] the implementation of United States policy on such investment.”<sup>136</sup> The Committee, however, was essentially toothless and unable to take decisive action to block harmful foreign investments until the Exon-Florio Amendment (Exon-Florio) to the Defense Production Act was passed by Congress in 1988.<sup>137</sup>

Exon-Florio granted the President, acting through the Committee, the power “to block proposed or pending foreign ‘mergers, acquisitions, or takeovers’ of ‘persons engaged in interstate commerce in the United States’ that threatened to impair the national security.”<sup>138</sup> Further, Treasury

134. See JACKSON, *supra* note 3, at 1. The current composition of CFIUS includes the head of the Treasury Department, Department of Justice, Department of Homeland Security, Department of Commerce, Department of Defense, Department of State, Department of Energy, Office of the U.S. Trade Representative, and Office of Science and Technology Policy. See *CFIUS Overview*, U.S. DEP’T TREASURY, <https://home.treasury.gov/policy-issues/international/the-committee-on-foreign-investment-in-the-united-states-cfius/composition-of-cfius> (last visited Mar. 9, 2021). CFIUS is an immensely powerful interagency committee, largely because “[t]here is no judicial review of CFIUS’ national security decisions, and if parties do not file with CFIUS and receive approval, there also is no statute of limitations on its authority to review already-consummated transactions.” See David Fagan & Brian Williams, *Intersection of National Security with M&A: The Committee on Foreign Investment in the United States: Why Does the United States Have Laws that Regulate M&A Activity from a National Security Perspective, and Why Are Those Laws Now Getting More Attention?*, 72 TAX EXECUTIVE 32, 35 (2020).

135. See JACKSON, *supra* note 3, at 4.

136. Exec. Order No. 11,858, 3 C.F.R. § 990 (1975).

137. See JACKSON, *supra* note 3, at 6–7. “Between 1975 and 1980, for instance, the Committee met only 10 times and seemed unable to decide whether it should respond to the political or the economic aspects of foreign direct investment in the United States.” *Id.* at 6. Further, between 1980 and 1987, CFIUS only investigated certain transactions flagged by the Department of Defense as harmful to national security. *Id.*

138. *Id.* at 7. Under the Byrd Amendment to Exon-Florio passed by Congress in 1992:

CFIUS [had to] investigate proposed mergers, acquisitions, or takeovers in cases where two criteria [were] met: (1) the acquirer is controlled by or acting on behalf of a foreign

regulations concerning Exon-Florio, issued in 1991, created a system of voluntary notification by “parties to an acquisition, and [] allowed for notices of acquisitions by agencies that are members of CFIUS.”<sup>139</sup>

Under Exon-Florio, CFIUS transformed from an ineffectual agency to one with immense influence over foreign investment into the U.S.<sup>140</sup> For example, the Committee became widely known for recommending that President George H.W. Bush block China National Aero-Technology Import and Export Corporation’s acquisition of U.S. aircraft parts producer MAMCO Manufacturing, Inc. in 1990.<sup>141</sup> Further, when French telecommunications company Alcatel aimed to acquire U.S. telecommunications firm Lucent Technologies in 2006, CFIUS approved the transaction, but only on the condition that Alcatel’s access to sensitive telecommunications information would be restricted and “that CFIUS could reopen its investigation if Alcatel materially failed to comply with the agreement.”<sup>142</sup> Thus, Exon-Florio represented the beginnings of CFIUS’s influence and willingness to block transactions seemingly harmful to U.S. national security.<sup>143</sup>

In 2007, Congress passed the Foreign Investment and National Security Act (FINSA),<sup>144</sup> which gave CFIUS formal statutory authority and further

government; and (2) the acquisition results in control of a person engaged in interstate commerce in the United States that could affect the national security of the United States. *Id.* at 9 (emphasis added). This amendment enhanced CFIUS’s scope because it could investigate acquirers who were simply acting on behalf of a foreign government. *Id.*

139. *Id.* at 8.

140. *Id.* at 7.

141. See Westbrook, *supra* note 2, at 665; see also JACKSON, *supra* note 3, at 8. The rationale behind this recommendation was that China National Aero-Technology Import and Export Corporation “reportedly had a reputation for circumventing trade law to obtain sensitive technologies.” See Westbrook, *supra* note 2, at 665.

142. See Westbrook, *supra* note 2, at 667. Before this transaction, CFIUS reviews were considered final, which incentivized parties to voluntarily file a notice with CFIUS preemptively because there would be no second-guessing the ultimate outcome. See JACKSON, *supra* note 3, at 8–9. After the transaction, however, allowing CFIUS the ability to reopen the review process increased the scope of its power and set a precedent of uncertainty for foreign investors attempting to acquire U.S. companies. *Id.*

143. See *supra* note 138 and accompanying text.

144. See Jonathan Wakely & Andrew Indorf, *Managing National Security Risk in an Open Economy: Reforming the Committee in Foreign Investment in the United States*, 9 HARV. NAT’L SECURITY J. 1, 22 (2018). Congress’s impetus for passing FINSA was a particular transaction in which CFIUS approved the acquisition of certain U.S. port operations by a U.K. company, Dubai Ports World, “an established port operator based in the United Arab Emirates.” *Id.* at 22. Due to the intense worry over threats of terrorism, the approval caused an uproar in Congress and an intense skepticism regarding CFIUS’s ability to “fully consider[] the effects of the transaction on U.S. critical

expanded its scope.<sup>145</sup> Specifically, FINSA required:

CFIUS to review a notified ‘covered transaction’ and to determine whether (1) the transaction threatens to impair national security;<sup>146</sup> (2) the foreign entity is controlled by a foreign government; or (3) the transaction would result in the control of any critical infrastructure<sup>147</sup> by or on behalf of any foreign person that could impair national security.<sup>148</sup>

Importantly, CFIUS only has jurisdiction when dealing with a “covered transaction,” which FINSA defined as any proposed or completed transaction that “could result in foreign control of any person engaged in interstate commerce in the United States.”<sup>149</sup> Regarding the definition of control, Treasury regulations included a safe harbor for “[any] transaction that results in a foreign person holding ten percent or less of the outstanding voting interest in a U.S. business[,] . . . but only if the transaction is solely for the purpose of passive investment.”<sup>150</sup> FINSA, however, also broadly defined control “as the power, direct or indirect, whether or not exercised, to determine, direct or decide matters affecting an entity.”<sup>151</sup> Therefore, by

infrastructure, especially with regard to port security and protection against terrorist threats.” *Id.*

145. *See* Westbrook, *supra* note 2, at 668. FINSA “[m]ade CFIUS membership permanent and added the Secretary of Energy, the Director of National Intelligence (DNI), and Secretary of Labor as ex officio members with the DNI providing intelligence analysis [as well as] granted authority to the President to add members on a case-by-case basis.” *See* JACKSON, *supra* note 3, at 10.

146. National security was never defined by FINSA but has been interpreted by CFIUS to encompass a wide array of areas such as Homeland Security and “critical infrastructure.” *See* Westbrook, *supra* note 2, at 670. Most notably, “CFIUS identified the possibility that Broadcom’s investment strategy would reduce Qualcomm’s research and development spending as a national security risk.” *Id.*

147. Treas. Reg. § 800.214 (2020). Assuming the transaction is a covered transaction, FINSA defined “critical infrastructure” as “systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security.” *Id.*

148. *See* Westbrook, *supra* note 2, at 668 (emphasis added). FINSA added the protection of “critical infrastructure” from foreign actors adverse to U.S. national security to CFIUS’s repertoire, arguably increasing its power and scope immensely. *See* Wakely & Indorf, *supra* note 144, at 22. FINSA also “provid[ed] for an increased role for Congress to receive briefings and certifications from CFIUS.” *Id.*

149. *See* Westbrook, *supra* note 2, at 668.

150. Treas. Reg. § 800.302 (2020).

151. *See* Westbrook, *supra* note 2, at 668. This broadened definition of control opened the door for the possibility that mere minority ownership stakes in U.S. companies or informal shareholder voting

widening the scope of “control,” FINSA allowed CFIUS to capture a far greater amount of transactions that could be evaluated under the new three-tiered review process.<sup>152</sup>

FINSA created a structured, three-tiered process for reviewing covered transactions, which includes review, investigation, and determination by the President.<sup>153</sup> To trigger the review process, FINSA granted authority to allow either a member of CFIUS or the President to begin the review, rather than relying only on voluntary notification by the parties.<sup>154</sup> Once the formal national security review is triggered, “CFIUS determines [whether] the transaction threatens to impair the national security of the United States; [whether] the foreign person is controlled by a foreign government; or [if] the transaction would result in control of any critical infrastructure by a foreign person thus impairing national security.”<sup>155</sup> If the transaction is found to potentially imperil national security or grant control of critical infrastructure to a foreign entity, CFIUS begins the investigation phase in which it works with the parties to resolve any national security issues.<sup>156</sup> Finally, if the issues cannot be resolved by agreement between CFIUS and the parties to the transaction, CFIUS may issue a negative recommendation to the President.<sup>157</sup>

While the President need not follow CIFIUS’s recommendation, “[t]he President may suspend or prohibit proposed or pending foreign acquisitions of U.S. businesses that threaten to impair national security.”<sup>158</sup> Only the President has the power to permanently block pending or proposed transactions,<sup>159</sup> but CFIUS has broad authority to mitigate national security threats and may “take any necessary actions in connection with the transaction to protect the national security of the United States.”<sup>160</sup> Overall, FINSA

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arrangements might constitute “control,” regardless of the 10% safe harbor provision. *Id.* at 668–69.

152. *Id.* at 671.

153. *Id.*

154. *Id.* at 672.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. See Peter Thomas et al., *A Primer on CFIUS: Navigating the Evolving U.S. National Security Foreign Investment Review Process*, ANTITRUST SOURCE 1, 4 (2018).

160. 50 U.S.C. § 4565(b)(2)(A) (2020). CFIUS has, in fact, wielded its power to “take any necessary actions” to protect national security with force, as evidenced by its ability to effectively prevent Broadcom from redomiciling in the U.S., thus removing Broadcom from CFIUS’s jurisdiction. See Thomas et al., *supra* note 159, at 5 (quoting 50 U.S.C. § 4565(i)(1)(A) (2020)); see also *CFIUS Intervenes in Broadcom’s Attempt to Buy Qualcomm*, *supra* note 1.



expanded the economic and national security importance of CFIUS and has led to sharp increases in the amount of foreign investor notices filed, number of CFIUS investigations, and number of notices withdrawn during the investigation phase.<sup>161</sup>

### III. THE “REGULATORY BAZOOKA” GETS AN UPGRADE

On August 13, 2018, FIRRMA was enacted into law, which enhanced CFIUS’s power to scrutinize minority investments that do not grant foreign control.<sup>162</sup> FIRRMA’s provisions have drastically increased CFIUS’s scope in a variety of ways, enabling the Committee to better safeguard U.S. critical technology, but arguably providing serious uncertainty.<sup>163</sup> FIRRMA’s Final Rules became effective on February 13, 2020 and encapsulate the Treasury’s final implementation of FIRRMA, taking into consideration all proposed comments and suggestions from stakeholders.<sup>164</sup>

161. See JACKSON, *supra* note 3, at 35. For example, in 2016, foreign investors filed 172 notices with CFIUS, but that number spiked to 237 in 2017. See Mario Mancuso, *CFIUS Report Shows Trump Admin’s Push to Curb Risky M&A*, KIRKLAND & ELLIS (Nov. 25, 2019), <https://www.kirkland.com/news/in-the-news/2019/11/cfius-report-shows-trump-admins-push-to-curb-risky>. Similarly, CFIUS conducted 79 investigations in 2016 and 172 in 2017. *Id.* Regarding notices withdrawn during the investigation phase, 21 were withdrawn in 2016 and 67 in 2017. *Id.* The trend of heightened CFIUS scrutiny continued into 2018, with 229 notices filed and 159 investigations. *Id.*

162. See Westbrook, *supra* note 2, at 679. One of the primary drivers for passing FIRRMA was Chinese foreign direct investment into the U.S. exploding from \$356 million in 2007 to \$45.2 billion in 2016. See Wakely & Indorf, *supra* note 144, at 22–23. Moreover, for many years, most transactions filed with CFIUS were from the United Kingdom: “Starting in 2012, however, Chinese acquirers filed more transactions with CFIUS than those from any other country, including the United Kingdom.” *Id.* at 23. Notably, “[a]ccording to FIRRMA’s sponsors, ‘China is weaponizing its investment in the U.S. to exploit national security vulnerabilities, including the backdoor transfer of dual-use U.S. technology and related know-how, aiding China’s military modernization and weakening the U.S. defense industrial base.’” *Id.* at 26. Further, FIRRMA’s sponsors admonished China’s quest to “vacuum up advanced U.S. technology,” and the Department of Defense called on Congress to expand CFIUS’s power to scrutinize minority investments into U.S. technology companies on the forefront of technological innovation. *Id.*

163. See *infra* Section IV.A. For example, “FIRRMA added to CFIUS’s authority the review of minority investments in U.S. critical technologies, critical infrastructure, and critical personal data, as well as certain real estate investments even where the Foreign Person does not take control of a U.S. Business. FIRRMA created the first mandatory CFIUS filings as well as ‘light’ filings, called Declarations, that require less information and pass through a faster review track.” REID WHITTEN ET AL., *THE CFIUS BOOK 7* (2d ed. 2020).

164. See *Treasury Releases Final Regulations to Reform National Security Reviews for Certain Foreign Investments and Other Transactions in the United States*, U.S. DEP’T TREASURY (Jan. 13, 2020), <https://home.treasury.gov/news/press-releases/sm872>.

### A. *The Final Rules: CFIUS's Scope Drastically Increases*

In order to thoughtfully analyze FIRRMA, its impact, and its potential uncertainties, a thorough breakdown of the relevant statutory provisions is in order.<sup>165</sup> FIRRMA is significant in that it broadens CFIUS's power to review foreign investment into U.S. businesses.<sup>166</sup> This is seen primarily in its broad definition of *covered transaction*, which constitutes not only a covered control transaction<sup>167</sup> and a covered investment,<sup>168</sup> but also a change in the rights of a foreign investor's existing investment in a U.S. firm "if that change could result in a covered control transaction or a covered investment."<sup>169</sup> Instead of being able to review foreign investments only where the foreign entity obtains control of a U.S. company, as under FINSA, under FIRRMA's added *covered*

165. See *infra* notes 167, 170, 171 and accompanying text.

166. See Farhad Jalinous et al., *CFIUS Finalizes New FIRRMA Regulations*, WHITE & CASE (Jan. 22, 2020), <https://www.whitecase.com/publications/alert/cfius-finalizes-new-firma-regulations>. The definition of U.S. business "means any entity, irrespective of the nationality of the persons that control it, engaged in interstate commerce in the United States." Treas. Reg. § 800.252 (2020). Note that in previous iterations of the definition of U.S. business, the Treasury defined it as "any entity engaged in interstate commerce in the United States, but only to the extent of its activities in interstate commerce." See Jalinous et al., *supra* note 166. In the Final Rules, however, the language "to the extent of its activities in interstate commerce" was removed. *Id.*

167. Note that the old avenue, such as described above regarding FINSA, of a foreign investor regularly obtaining control of a U.S. company still exists under the Final Rules (known as covered control transactions). See Treas. Reg. §§ 800.208, 800.301 (2020). Under the Final Rules, a covered control transaction is "[a] transaction which, irrespective of the actual arrangements for control provided for in the terms of the transaction, results or could result in *control* of a U.S. business by a foreign person." Treas. Reg. § 800.301 (2020) (emphasis added). Note FIRRMA's broad definition of "control," defining the term as "the power, direct or indirect, whether or not exercised, . . . to determine, direct, take, reach, or cause decisions regarding . . . important matters affecting an entity." Treas. Reg. § 800.208 (2020). The Final Rules explain, however, that where the investment is not for the *sole purpose of passive investment*, a transaction resulting in *any* foreign person holding more than 10% of the outstanding voting interest in a U.S. company will be considered a covered control transaction. Treas. Reg. § 800.302(b) (2020). The Final Rules define "solely for the purpose of passive investment" as when a foreign investor does not:

[P]lan or intend to exercise control and—(1) Is not afforded any rights that if exercised would constitute control; (2) Does not acquire any access, rights, or involvement specified [in] § 800.211(b); (3) Does not possess or develop any purpose other than passive investment; and (4) Does not take any action inconsistent with holding or acquiring such interests solely for the purpose of passive investment.

Treas. Reg. § 800.243 (2020).

168. See *infra* note 170 and accompanying text.

169. Treas. Reg. § 800.213(c) (2020). As explained *infra*, the provision relating to a change in pre-existing rights has serious implications for VCs and foreign investors in U.S. startups. See *infra* Section IV.A.

*investment* definition, CFIUS is now able to review non-controlling investments by a foreign person that either grant the person access to certain material nonpublic technical information, or give the power to influence decisionmaking regarding critical technology as well as the sensitive personal data of U.S. citizens.<sup>170</sup> A covered investment only applies if the business is designated as a *TID U.S. business*, meaning that the business either “[p]roduces, designs, tests, manufactures, fabricates, or develops one or more critical technologies[,]” performs functions relating to covered critical infrastructure, or “[m]aintains or collects, directly or indirectly, sensitive personal data of U.S. citizens.”<sup>171</sup> Therefore, in analyzing whether a minority

170. Treas. Reg. § 800.211 (2020). Specifically, “covered investment” is defined as:

[A]n investment, direct or indirect, by a foreign person other than an excepted investor [that] . . . [a]ffords the foreign person[:] (1) Access to any material nonpublic technical information in the possession of the TID U.S. business; (2) Membership or observer rights on, or the right to nominate an individual to a position on, the board of directors or equivalent governing body of the TID U.S. business; or (3) Any involvement, other than through voting of shares, in substantive decisionmaking of the TID U.S. business regarding: (i) The use, development, acquisition, safekeeping, or release of sensitive personal data of U.S. citizens maintained or collected by the TID U.S. business; (ii) The use, development, acquisition, or release of critical technologies; or (iii) The management, operation, manufacture, or supply of covered investment critical infrastructure.

*Id.* Analyzing whether an investment provides the foreign investor with “rights in Substantive Decisionmaking may mean wading into the grey area of that term’s definition.” WHITTEN ET AL., *supra* note 163, at 15. Furthermore, one “can count on CFIUS taking the expansive view of whether or not a certain power is considered Substantive Decisionmaking.” *Id.* However, the Final Rules explain that “Substantive Decisionmaking” is “the process through which decisions regarding significant matters affecting an entity are undertaken” in areas such as pricing, sales, supply arrangements, and corporate strategy. *Id.* at 16.

171. Treas. Reg. § 800.248 (2020). TID stands for “technology, infrastructure, and data.” *Fact Sheet: Final CFIUS Regulations Implementing FIRRMA*, U.S. DEP’T TREASURY 1, 2 (Jan. 13, 2020). Critical technologies include:

[D]efense articles and defense services included on the United States Munitions List; certain items included on the Commerce Control List (CCL); certain nuclear-related facilities, equipment, parts and components, materials, software, and technology; select agents and toxins; and emerging and foundational technologies controlled for export pursuant to section 1758 of the Export Control Reform Act of 2018 (ECRA).

Jalinous et al., *supra* note 166. Regarding critical infrastructure, where U.S. firms “perform specified functions . . . with respect to critical infrastructure across subsectors such as telecommunications, utilities, energy, and transportation[,]” the firm may be given TID U.S. business status. *Fact Sheet, supra*, at 3. Regarding “Covered Investment Critical Infrastructure,” which is a smaller subset of critical infrastructure added by FIRRMA, “[t]he specific list of Covered Investment Critical Infrastructure is found in Column 1 of Appendix A to Part 800 and the covered related functions are found in Column 2.” WHITTEN ET AL., *supra* note 163, at 20. Finally, FIRRMA defined sensitive personal data:

To include ten categories of data maintained or collected by U.S. businesses that (i) target

investment may generally fall under CFIUS's expanded purview, the first step is to ascertain whether the business is a TID U.S. business, and the second step is to evaluate whether the investment in that business constitutes a covered investment.<sup>172</sup>

Even if the investment constitutes a covered investment in a TID U.S. business, certain exceptions relating to direct investments by foreign investors and investments made by a VC's foreign LPs exist to avoid CFIUS scrutiny.<sup>173</sup> For example, when a foreign investor invests directly into a TID U.S. business, the Final Rules provide an exception to having the transaction fall under the definition of covered investment where the foreign investor qualifies as an *excepted investor* (the "excepted investor exception").<sup>174</sup> An excepted investor is one who "is a national of one or more excepted foreign states and is not also a national of any foreign state that is not an excepted foreign state."<sup>175</sup> Further, when analyzing whether a foreign *entity* is an

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or tailor products or services to certain populations, including U.S. military members and employees of federal agencies with national security responsibilities, (ii) collect or maintain such data on at least one million individuals, or (iii) have a demonstrated business objective to maintain or collect such data on greater than one million individuals and such data is an integrated part of the U.S. business's primary products or services.

*Fact Sheet, supra*, at 3; *see also* Treas. Reg. § 800.241 (2020). Among the ten listed categories of "identifiable data" included in the sensitive personal data definition are health-related data, personal physical or psychological data, non-public electronic communications between people, geolocation data, and biometric data. Treas. Reg. § 800.241 (2020). Aside from the ten categories of identifiable data included in the sensitive personal data definition, FIRRMA also includes genetic data, which "includes the results of an individual's genetic tests, including any related genetic sequencing data, whenever such results constitute identifiable data." WHITTEN ET AL., *supra* note 163, at 26–27.

172. *See Fact Sheet, supra* note 171, at 2–3.

173. *See* Treas. Reg. §§ 800.219, 800.307 (2020).

174. Treas. Reg. § 800.219 (2020). Note that the excepted investor exception only applies to covered investments and *not* covered control transactions, which applies to *any* foreign investor. *Compare* Treas. Reg. § 800.210 (2020) (defining a covered control transaction as one involving any foreign investor), *with* Treas. Reg. § 800.211 (2020) (defining a covered investment to exclude an excepted investor). So, "Excepted Investors are excepted from CFIUS jurisdiction, but only for non-controlling investments." *See* WHITTEN ET AL., *supra* note 163, at 30.

175. Treas. Reg. § 800.219 (2020). CFIUS initially determined Australia, Canada, and Great Britain counted as excepted states due to their intelligence sharing agreements with the U.S. *See* John M. Beahn & Robert S. Larussa, *Final CFIUS Regulations Implement Significant Changes by Broadening Jurisdiction and Updating Scope of Reviews*, SHEARMAN & STERLING (Jan. 14, 2020), <https://www.shearman.com/perspectives/2020/01/final-cfius-regulations-implement-changes-by-broadening-jurisdiction-and-updating-scope-of-reviews>. CFIUS may continue to slowly add to the list of excepted states, and those countries already on the list will remain from February 13, 2020 for a period of two years upon which CFIUS will determine whether the countries should continue to remain on the list. *Id.*

excepted investor, the entity must meet a variety of requirements, including being organized under the laws of an excepted state or the U.S., having its principal place of business in an excepted state or the U.S., having 75% of its board of directors comprised of nationals from the U.S. or an excepted state, prohibiting a non-excepted foreign investor in the entity in question from holding more than 10% of its voting shares, and having “[a]t least 80% [or] 5% (depending on whether the entity is primarily traded on an exchange) of the voting interests . . . held by nationals of an Excepted Foreign State or of the United States.”<sup>176</sup>

Furthermore, where an indirect investment into a TID U.S. business is made by a VC’s foreign LP and that investment affords the foreign LP “membership . . . on an advisory board or a committee of the fund[,]” FIRRMA generally exempts these types of investments from being considered a covered investment where, among other requirements, the general partner of the fund is not a foreign person, the foreign investor does not have the power to control the investment fund, and the foreign investor is not given access rights to material nonpublic technical information (the “investment fund exception”).<sup>177</sup> Therefore, even with this narrow exception for foreign LPs under certain circumstances, FIRRMA’s provisions will undoubtedly enhance CFIUS’s jurisdiction over foreign investments into the U.S.<sup>178</sup>

176. WHITTEN ET AL., *supra* note 163, at 30–31 (explaining that if the entity is primarily traded on an exchange, it must have at least 50% of its voting interests held by excepted foreign investors or U.S. investors and 80% of its voting interests held by such investors if the entity is not primarily traded on an exchange); Treas. Reg. §§ 800.219, 800.233 (2020). Regarding an entity’s “principal place of business,” FIRRMA defines this as “the primary location where its management directs, controls, or coordinates the entity’s activities, or, in the case of an investment fund, where the fund’s activities and investments are primarily directed, controlled, or coordinated by or on behalf of the general partner, managing member, or equivalent.” See WHITTEN ET AL., *supra* note 163, at 31. The 75% board requirement in the Final Rules was a marked shift from the Treasury’s initial stance in the Interim Rules, which required the *entire* board to consist of members from the U.S. or an excepted foreign state. See Beahn & Larussa, *supra* note 175. The prohibition of non-excepted foreign investors in an entity holding more than 10% of its voting shares is to ensure a controlling shareholder situation does not arise, effectively making the entity a non-excepted foreign investor in substance. *Id.*

177. Treas. Reg. § 800.307 (2020). Regarding the foreign LP’s power to control the investment fund, FIRRMA specifies that such control constitutes the power to approve, disapprove, or otherwise control investment decisions of the investment fund; (ii) [t]o approve, disapprove, or otherwise control decisions made by the general partner, managing member, or equivalent related to entities in which the investment fund is invested; or (iii) [t]o unilaterally dismiss, prevent the dismissal of, select, or determine the compensation of the general partner, managing member, or equivalent.

*Id.*

178. See *infra* Section IV.A.

*B. The Final Rules: FIRRMA's New Mandatory Filing Requirements*

The notice process under FIRRMA is similar to the process under FINSA, with the parties to a potential covered control or covered investment transaction able to give notice to CFIUS through the voluntary notice process.<sup>179</sup> Further, though the notice process is largely voluntary, where CFIUS identifies a transaction that may constitute a covered transaction and where no voluntary notice has been filed, CFIUS has the power to request that the parties file a notice for review.<sup>180</sup> Most important, however, are FIRRMA's new mandatory filing requirements.<sup>181</sup> First, a mandatory filing requirement is triggered if a covered transaction occurs in a TID U.S. business that develops certain critical technologies.<sup>182</sup> Second, a mandatory filing is

179. Treas. Reg. § 800.501 (2020).

180. *Id.*

181. See Jalinous et al., *supra* note 166.

182. Treas. Reg. § 800.401(c) (2020). More specifically, where either a covered investment in or potential foreign control of a TID U.S. business engaged in the development of one of twenty-seven listed critical technologies occurs, the parties to the transaction *must* submit a filing with CFIUS. *Id.* Some of the critical technology industries include, among many others, aircraft manufacturing, electronic computer manufacturing, R&D in nanotechnology, R&D in biotechnology, and semiconductor manufacturing. Treas. Reg. app. § 800 (2020). Identifying whether a U.S. business engaged in the development of one of the twenty-seven enumerated critical technologies had been based on each company's self-assigned North American Industry Classification System (NAICS) code. See Ivan A. Schlager, et al., *CFIUS Goes Back to the Future by Tying Mandatory Filings Pertaining to Critical Technologies to U.S. Export Controls Assessments*, KIRKLAND & ELLIS (Oct. 21, 2020), <https://www.kirkland.com/publications/kirkland-alert/2020/10/cfius-critical-technologies>. With hundreds of NAICS codes in existence and the ability of companies to self-assign, however, "[t]his injected a certain degree of subjectivity into the process of assessing whether a particular investment might trigger a mandatory CFIUS filing." *Id.* A final rule enacted by the Treasury on October 15, 2020

eliminate[d] the NAICS code prong of the critical technology filing assessment and replace[d] it with a test focused solely on the U.S. export controls classification of the technology at issue and whether a U.S. export authorization would be required to export the technology to certain foreign persons involved in the transaction—even if an export from the U.S. never actually occurs.

*Id.* Unfortunately, while this added rule creates more certainty, "a U.S. export controls assessment potentially could be a highly technical and complicated exercise, and could be burdensome for early-stage companies that may lack the funding and the resources to undertake such an assessment." *Id.* Overall, to determine whether a mandatory filing is triggered in this scenario, the relevant parties to the transaction must: (1) determine the U.S. export control status as well as the classification of the technology "[p]roduced, [d]esigned, [t]ested, [m]anufactured, [f]abricated[,] or [d]eveloped by the U.S. business"; (2) assess "[w]hether a U.S. Export Authorization [w]ould [b]e [r]equired in [c]onnection with a [h]ypothetical [e]xport-[r]elated [t]ransaction"; and (3) assess whether any applicable Export Administration Regulation (EAR) license exceptions exist to avoid the mandatory filing. *Id.*

also triggered if a covered transaction results in a “substantial interest in a TID U.S. business by a foreign person in which the national or subnational governments of a single foreign state (other than an excepted foreign state) have a substantial interest.”<sup>183</sup> The Final Rules impose penalties for failure to make a mandatory filing “not to exceed \$250,000 or the value of the transaction, whichever is greater.”<sup>184</sup> Ultimately, the Final Rules implementing FIRRMA make clear that “CFIUS’s long-standing history as a purely voluntary process” has come to an end.<sup>185</sup>

#### IV. WALKING A TIGHTROPE: BALANCING CAPITAL INVESTMENT WITH NATIONAL SECURITY

The Final Rules implementing FIRRMA were written to give CFIUS broad oversight powers over foreign minority investments, and this will create added regulatory uncertainty that will increase costs to U.S. startups and VCs seeking to raise capital from abroad.<sup>186</sup> From a policy perspective, however, the potential benefits of increased oversight may necessitate the uncertainty

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183. Treas. Reg. § 800.401(b) (2020). Where a covered transaction results in a substantial interest in a TID U.S. business, this “substantial interest” refers to “a voting interest, direct or indirect, of 25 percent or more.” Treas. Reg. § 800.244(a) (2020). Where a non-excepted foreign national government has a substantial interest in the foreign investor, this “substantial interest” refers to “a voting interest, direct or indirect, of 49 percent or more.” *Id.* So, if a foreign investor wishes to acquire a 30% voting interest in a TID U.S. business and a foreign national government has a voting interest of less than 49% in the foreign investor, the foreign investor would be acquiring a substantial interest in the U.S. company but the foreign government would not have a substantial interest in the foreign investor to trigger a mandatory filing. See Treas. Reg. § 800.244(d)(2) (2020). “[F]or entities whose activities are primarily directed, controlled or coordinated by or on behalf of a managing partner, managing member or equivalent, the term ‘voting interest’ is construed to mean 49% or more of the interest in the general partner, managing member, or equivalent.” See Schlager et al., *supra* note 182. Further, “any interest of a parent, as that term is defined for purposes of the CFIUS regulations (e.g., holding at least 50% of the outstanding voting interest in an entity), will be deemed to be a 100% interest in any entity of which that person is a parent.” *Id.*

184. See Treas. Reg. § 800.901 (2020); Jalinous et al., *supra* note 166.

185. See Michael E. Leiter et al., *CFIUS’ Final Rules: Broader Reach, Narrow Exceptions and Foretelling Future Change*, SKADDEN (Jan. 16, 2020), <https://www.skadden.com/insights/publications/2020/01/cfius-final-rules>. Notably, even if a foreign investment is not subject to a mandatory CFIUS filing “and parties proceed without filing a Voluntary Notice, CFIUS retains the same authority it has always had to initiate a post-closing review and impose conditions *ex post facto* or even order the unwinding of the transaction after the fact.” WHITTEN ET AL., *supra* note 163, at 41.

186. See *infra* Section IV.A; Kia Kokalitcheva, *Venture Capital Industry Wants More Clarity on Foreign Investment Rules*, AXIOS (Oct. 18, 2019), <https://www.axios.com/venture-capital-cifus-foreign-investment-rules-b2fdfa6d-5b67-4405-be58-5539df83f5e5.html>.

costs.<sup>187</sup> On the one hand, crafting Final Rules which are broader in scope helps to enhance the vision of CFIUS's watchful eye, thereby making it easier to block a variety of transactions involving foreign capital coming from investors who are, for instance, connected to hostile foreign governments.<sup>188</sup> Rules which are too expansive, however, may drive capital away from U.S. startups on the front-lines of innovation and disincentivize deals with investors who may not pose any national security threat for the sake of blocking the "bad" capital investment.<sup>189</sup>

#### *A. Stifling Foreign Capital: Identifying and Managing the Uncertainty*

Under the Final Rules enacted by the Treasury, FIRRMA will create added uncertainty for the VC ecosystem and its foreign investors.<sup>190</sup> The first potential area of uncertainty relates to the broad definition of "control."<sup>191</sup> The Treasury made clear in the Final Rules that it decided to make no changes to or elaborations on control's definition.<sup>192</sup> Leaving the definition broad is in CFIUS's interest in order to police greater amounts of foreign investment transactions, but the definition will inevitably add uncertainty costs to U.S. startups, venture firms, and foreign investors.<sup>193</sup>

187. *See infra* Section IV.B.

188. *See infra* Section IV.B.

189. *See infra* Section IV.B. These added costs, at least from the Treasury's and Congress's point of view, are a worthy tradeoff for increased scrutiny of foreign investors coming from countries that may be acting adversely to the U.S. *See* Michael Brown & Pavneet Singh, *China's Technology Transfer Strategy: How Chinese Investments in Emerging Technology Enable a Strategic Competitor to Access the Crown Jewels of U.S. Innovation*, DEF. INNOVATION UNIT EXPERIMENTAL 1, 22–23, 42 (Jan. 2018), [https://admin.govexec.com/media/diux\\_chinatechnologytransferstudy\\_jan\\_2018\\_\(1\).pdf](https://admin.govexec.com/media/diux_chinatechnologytransferstudy_jan_2018_(1).pdf). Whatever the dollar amount of foreign capital or costs of compliance with FIRRMA by U.S. businesses that is ultimately foregone, it is clear that policymakers believe such an amount pales in comparison to the need to fight foreign industrial espionage. *Id.* at 15, 23.

190. *See* Brown & Singh, *supra* note 189, at 23.

191. *See* Treas. Reg. § 800.208(a) (2020).

192. *See* Provisions Pertaining to Certain Investments in the United States by Foreign Persons, 85 Fed. Reg. 3112, 3114–15 (Jan. 17, 2020). Specifically, the Treasury explained that "FIRRMA maintains the Committee's jurisdiction over any transaction which could result in foreign control of any U.S. business, and provides no legislative direction to substantively narrow the existing definition of 'control.'" *Id.* at 3114–15.

193. *Id.* The Treasury noted that it decided not to make any changes to the definition of control amidst public comment "that the threshold for control is too low, thereby discouraging foreign investment in U.S. companies." *Id.* at 3114.



For example, under the investment fund exception,<sup>194</sup> foreign investors who qualify as LPs are generally shielded from having their investment fall under the covered investment definition so long as they do not exercise any *control* over the VC's management, the VC's investment decisions, and the decisions the VC firm makes with respect to the businesses it invests in, among other requirements.<sup>195</sup> The definition of "control" in its broadest sense could mean the indirect power (whether or not recognized) to direct important matters of an entity.<sup>196</sup> There is a slim chance a foreign limited partner could obtain enough indirect control over a VC's portfolio company through the investment of the VC firm itself (being that they are indeed *limited* partners).<sup>197</sup> However, this indirect power to "otherwise control" a VC's investment decision should put the VC ecosystem on guard from mere *influence* by foreign LPs on a VC firm's advisory board regarding any matter related to the business of the fund.<sup>198</sup> Therefore, U.S. startups and VC firms will have to maintain careful diligence of all foreign investors (including the VC's foreign LPs) and may be forced to err on the side of abandoning deals where the foreign investor is not an excepted investor, particularly if the investor comes from a country like China.<sup>199</sup>

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194. See *supra* note 177 and accompanying text.

195. Treas. Reg. § 800.307 (2020).

196. See *supra* note 167 and accompanying text; see also WHITTEN ET AL., *supra* note 163, at 48 (explaining that "[w]hile direct control of a business's important matters may be evident, indirect control may be harder to identify").

197. See Jalinous et al., *supra* note 166.

198. *Id.* It is important for VCs with advisory boards to bear this point in mind if they are thinking of attracting foreign capital and for the potential foreign investors themselves. *Id.* While membership on a VC's advisory board by a foreign LP is not dispositive of whether the investment can be deemed a covered control or covered investment transaction, "[w]hether such indirect investment *would otherwise be* such a covered transaction would still need to be assessed based on the respective criteria for covered control transactions and covered investments." *Id.* Certainly a foreign LP could not have the power to directly approve or disapprove of any investment decision of the fund, but could the foreign LP provide mere recommendations or insight to the GP regarding an investment or decisions relating to the VC's U.S. startups? *Id.* Based on the Final Rules, if the foreign investor is not an excepted investor, the answer is *absolutely not. Id.*

199. See Letter from NVCA to Thomas Feddo, Assistant Sec'y for Inv. Sec., U.S. Dept. of the Treasury (Oct. 17, 2019) [hereinafter Letter from NVCA]. The NVCA urged the Treasury to articulate how a VC firm might insulate its foreign LPs from exercising the requisite control to trigger a mandatory filing, explaining that "[d]oing so would enable venture funds to take advantage of more foreign capital and thus expand the pool of capital available to U.S. businesses." *Id.* Note that if a VC's foreign LP decided to invest directly in a portfolio company, even if it argued that the investment constituted less than 10% of the voting interest and that the investment was strictly passive (meeting the regulatory definition of "[t]ransactions that are not covered control transactions"), if evidence arose

Another issue relating to the investment fund exception is that it applies only where the fund is managed by general partners who are not foreign persons.<sup>200</sup> This could create issues for a VC firm where one of its GPs is a U.S. citizen, but another GP is technically a foreign person but from an excepted country.<sup>201</sup> The Treasury should add clarity to the VC industry by confirming that foreign GPs who are nationals of excepted foreign states also qualify under the investment fund exception.<sup>202</sup>

In addition to a covered control transaction or covered investment, a foreign investment can constitute a covered transaction when the foreign investor's rights with respect to the U.S. business *change* where "that change *could* result in a covered control transaction or a covered investment."<sup>203</sup> Where a foreign investor directly invests in a VC's portfolio company, this third avenue of triggering a covered transaction arguably grants CFIUS its most expansive power: the power to review and scrutinize *existing* foreign minority investments for any changes that would make the investment a covered investment.<sup>204</sup> Therefore, foreign investors investing in multiple funding rounds in TID U.S. businesses must constantly guard against any changes in their rights that could trigger a costly mandatory filing process.<sup>205</sup> The "change in rights" avenue for triggering a covered investment will create added regulatory compliance costs for many high-tech startups that are considered TID U.S. businesses because such companies must often share

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that the investor merely *planned* or *intended* to exercise the requisite control, the investment would not be seen as passive and could thus be a covered control transaction. *See* Treas. Reg. §§ 800.243, 800.302 (2020).

200. Treas. Reg. § 800.307(a)(2) (2020).

201. *See* Letter from NVCA, *supra* note 199. The NVCA highlighted this issue to the Treasury during FIRRMA's comment period and explained that foreign GPs often "include a longstanding U.S. resident on a green card or an individual resident in a foreign country who may be charged with identifying new investment for the fund and possibly bring the founders of a company to the U.S.[.] to start a new American company." *Id.* Further, "many diversified investment funds have general partners who are foreign citizens" as this helps VCs to gain from the expertise of the top investors around the world and their connections. *Id.*

202. *See supra* note 201 and accompanying text.

203. Treas. Reg. § 800.213(c) (2020) (emphasis added).

204. *Id.* Interestingly, while the text of the regulation explains that this change in rights avenue applies to a change of rights "with respect to a U.S. business *in which the foreign person has an investment*," it appears that a potential change of rights of an LP in an investment fund (i.e., where the LP is subsequently granted access to material nonpublic technical information or sensitive personal data) may also lead to the same outcome due to the fact that "covered investment" also covers "indirect" investments as well. *Id.* (emphasis added); Treas. Reg. § 800.211 (2020).

205. *See supra* note 184 and accompanying text.

information with investors regarding the company's business and also deal with individuals' personal data.<sup>206</sup>

Regarding FIRRMA's definition of "material nonpublic technical information," this information can be one of two things.<sup>207</sup> Material nonpublic technical information could either be information that "[p]rovides knowledge, know-how, or understanding, in each case not available in the public domain, of the design, location, or operation of covered investment critical infrastructure" *or* information "not available in the public domain [that] is necessary to design, fabricate, develop, test, produce, or manufacture a critical technology, including processes, techniques, or methods."<sup>208</sup> While the definition makes clear that the information must not be in the public domain, it also appears that information granting mere knowledge or understanding of the *operation* of critical infrastructure counts as material nonpublic technical information.<sup>209</sup> How the word "operation" combines with the entire sentence arguably forces venture funds to make sure both foreign LPs and foreign investors investing in venture-backed startups directly are insulated from *any* kind of information that could lead them to merely understanding how a product works.<sup>210</sup> Therefore, in order to help VCs and high-tech startups avoid

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206. See Jalinous et al., *supra* note 166.

207. Treas. Reg. § 800.232 (2020). This language matters because under the definition of covered investment, any investment that affords a foreign investor "[a]ccess to any material nonpublic technical information in the possession of [a] TID U.S. business" may constitute a covered investment. Treas. Reg. § 800.211(b)(1) (2020).

208. Treas. Reg. § 800.232 (2020). "CFIUS's new jurisdiction under FIRRMA is established once a foreign investor in a TID U.S. Business will be afforded access to material nonpublic technical information, *regardless of whether or when the investor exercises the right of access.*" See WHITTEN ET AL., *supra* note 163, at 14 (emphasis added).

209. Treas. Reg. § 800.232 (2020).

210. *Id.* An important point of clarity would be specific examples from the Treasury on the difference between knowing how a product or process works and knowing how to engineer that product. See Provisions Pertaining to Certain Investments in the United States by Foreign Persons, 85 Fed. Reg. 3112, 3117 (Jan. 17, 2020). While the Interim Rules provided an example of a foreign corporation receiving source code not available to the public as a part of its minority investment as falling under the material nonpublic technical information definition, this example did not clarify whether lesser kinds of information contained in investment presentations or sales materials would suffice to meet the definition. See Letter from NVCA, *supra* note 199. Further, on this point, the NVCA explained:

Many venture investors have become concerned that information such as nonpublic technical milestones—i.e., information that explains the capabilities of a technology but says nothing about how to replicate those capabilities—is also covered. Access to such information helps investors monitor the progress of their investments; without being able to monitor their investments, those investors are less likely to invest into innovative

wasting time and money that could instead go to business development and raising needed capital, the Treasury should consider deleting the first definition<sup>211</sup> of material nonpublic technical information and fully retaining the second.<sup>212</sup>

This recommendation would cure the overinclusive scope of material nonpublic technical information for two reasons.<sup>213</sup> First, retaining the second definition still prevents foreign actors from obtaining any information that is necessary to design the technology in question.<sup>214</sup> Second, deleting the first definition allows VCs or their startups to release tailored information that may not be public regarding the product or process for informational purposes to foreign investors, but does not provide nearly enough information for a foreign investor to design the technology.<sup>215</sup> This suggestion would reduce uncertainty for the VC community regarding the type of material nonpublic technical information that may be released to foreign investors.<sup>216</sup> Further,

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technologies in the United States.

*Id.* The Treasury responded to NVCA's request in the Final Rules for an example regarding whether material nonpublic technical information includes technical milestones, and explained that mere notification of the milestone, without releasing technical information relating to the milestone, does not constitute such information. Treas. Reg. § 800.232(c)(2) (2020). Based on this example, one may understand that notification of a milestone is acceptable, but it is still unclear as to whether an explanation of the capabilities of a technology is permissible. *Id.* Further, the Treasury made clear that the financial performance of a startup can be transmitted to a venture fund's foreign LPs and this does not constitute material nonpublic technical information. See Jeff Farrah, *CFIUS & VC: 3 Takeaways from the Final Rules and What Investors Must Know*, NAT'L VENTURE CAP. ASS'N (Jan. 27, 2020), <https://nvca.org/cfius-vc-3-takeaways-from-the-final-rules-and-what-investors-must-know/>. Ultimately, however, the Treasury noted that what constitutes material nonpublic technical information will come down to the facts and circumstances of each case, arguably not ameliorating the uncertainty for the VC community when the information is anything other than non-technical milestones and financial information. See Treas. Reg. § 800 (2020).

211. Treas. Reg. § 800.232(a)(1) (2020). For instance, a necessary limit would be deleting the language relating to information leading to "the design, location, or operation of covered investment critical infrastructure," since it is essentially covered by the second definition, but potentially retaining the language regarding location of critical infrastructure as well as "vulnerability information such as that related to physical security or cybersecurity," which is not necessarily included in the second definition but is important to national security. *Id.*

212. Treas. Reg. § 800.232(a)(2) (2020).

213. See *infra* notes 214–217 and accompanying text.

214. See Letter from NVCA, *supra* note 199.

215. See *supra* note 210 and accompanying text.

216. See *supra* notes 210, 211 and accompanying text. CFIUS blocked Esko Bionics, "a U.S. company manufacturing robotic exoskeletons for medical and industrial use," from "enter[ing] into a joint venture with two Chinese parties . . . to develop and service the exoskeleton market in China and certain other Asian markets." See Paul Marquardt et al., *CFIUS Blocks Joint Venture Outside the*

allowing foreign investors to receive some nonpublic information about a critical technological product or process in certain cases may increase the amount they invest in the U.S. business.<sup>217</sup>

The Final Rules explain that a foreign investment may become a covered investment where a foreign investor's direct or indirect investment in a TID U.S. business affords the foreign investor any involvement in the "substantive decisionmaking of the TID U.S. business regarding . . . [t]he use, development, acquisition, safekeeping, or release of *sensitive personal data*"<sup>218</sup> of U.S. citizens maintained or collected by the TID U.S. business."<sup>219</sup> Further, the Final Rules explain that sensitive personal data covers "identifiable data"; where the foreign investor receives such data and has the *ability* to de-anonymize the data, this could turn the investment into a covered investment.<sup>220</sup> Interestingly, with respect to sensitive personal data, triggering

*United States, Releases 2018–2019 Data, and Goes Electronic*, CLEARY GOTTSLIEB (June 3, 2020), <https://www.clearytradewatch.com/2020/06/cfius-blocks-joint-venture-outside-the-united-states-releases-2018-2019-data-and-goes-electronic/>. Even though the Chinese parties' investment was under 10% and no assets were acquired by the joint venture as part of the transaction, CFIUS likely blocked the transaction because it gave the Chinese investors access to material nonpublic technical information with respect to critical technologies. *Id.* "The theory may have been that because the JV coupled the small equity investment with the IP license (which, again based on public disclosure, may have involved 'critical technology' in the view of CFIUS), the investment resulted in the access to technology." *Id.*

217. See Letter from NVCA, *supra* note 199 (explaining that without clarity on the ambiguities remaining in FIRRMA, foreign investment will be negatively impacted by causing foreign "investors to step back from the U.S. market until the fog has lifted and instead direct their investments to other countries, including economic rivals of the United States").

218. See *supra* notes 170, 171 and accompanying text.

219. Treas. Reg. §§ 800.211(b)(3), 800.211(b)(3)(i) (2020) (emphasis added). Granting CFIUS oversight over minority investments that may provide access to sensitive personal data will implicate "many venture-back[ed] startups." See Farrah, *supra* note 210.

220. See Provisions Pertaining to Certain Investments in the United States by Foreign Persons, 85 Fed. Reg. 3112, 3117. "Identifiable data" includes ten categories of data ranging from individual financial data to an individual's geolocation data. See Treas. Reg. § 800.241 (2020); *supra* note 171 and accompanying text. FIRRMA's addition of "Identifiable Data is the CFIUS trap most likely to catch foreign investors and U.S. target companies unaware." See WHITTEN ET AL., *supra* note 163, at 24. The TID U.S. business will have met the sensitive personal data definition once it is found to (1) "[t]arget[] or tailor[] products or services to any U.S. executive branch agency or military department with intelligence, national security, or homeland security responsibilities," or (2) collect such identifiable data on more than 1 million individuals (not necessarily U.S. citizens), or (3) have "a demonstrated business objective" in collecting such identifiable data on more than 1 million individuals and the data falls into one of the eleven categories of types of sensitive personal data under the Final Rules. Treas. Reg. § 800.241(a)(1)(i) (2020). Further, this definition of "identifiable data" is broad in that it may "include[] data considered 'deidentified' under other regulatory frameworks, such as the Health Insurance Portability and Accountability Act (HIPAA) and the California Consumer

a covered investment requires that the foreign investor be *involved in the substantive decisionmaking* regarding such data, whereas receiving mere *access* to material nonpublic technical information is enough to trigger a covered investment.<sup>221</sup> This distinction is notable because the need to safeguard national security should involve protecting the sensitive personal data of Americans just as much as it involves preventing foreign investors from reverse engineering novel U.S. innovations by gaining access to material nonpublic technical information.<sup>222</sup> But what happens if a non-expected foreign investor receives access to sensitive personal data and has the ability to de-anonymize it, but is not technically involved in the substantive decisionmaking regarding the data's "use, development, acquisition, safekeeping, or release"?<sup>223</sup> It is unclear whether this alone would make the transaction a covered investment or not, and further guidance from the Treasury on this point would help reduce confusion faced by startups and VCs.<sup>224</sup> It would make sense for the Treasury to use the same language it used with material nonpublic technical information in saying that a non-expected foreign investor who receives *access* to sensitive personal data will trigger a

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Privacy Act (CCPA).” See Laura E. Jehl, *Spotlight on Sensitive Personal Data as Foreign Investment Rules Take Force*, NAT’L L. REV. (Feb. 18, 2020), <https://www.natlawreview.com/article/spotlight-sensitive-personal-data-foreign-investment-rules-take-force>.

221. Treas. Reg. § 800.211(b) (2020).

222. See Jehl, *supra* note 220. As an example of this point, sensitive health information has been of particular importance to CFIUS, with the Committee using its power to kill foreign investment transactions involving “a dating app for LGBTQ individuals” as well as “an online patient forum.” *Id.*

223. See Treas. Reg. § 800.211(b)(3) (2020). At least as of now, foreign LPs who are non-expected investors and have indirect minority investments in U.S. businesses through VCs are unlikely to necessitate, with respect to sensitive personal data, any voluntary filings with the Committee as long as the investment fund exception continues to be satisfied. See *supra* note 177 and accompanying text. Startups dealing with foreign investors who are *not* part of the investment fund structure, however, may find that a voluntary filing is necessary unless they can ensure the foreign investors are insulated from any involvement in decisions regarding sensitive personal data. See Jehl, *supra* note 220.

224. See Treas. Reg. § 800.211(b) (2020). While the language of the regulations themselves could provide greater clarity, in discussing the comments received during the interim period on the definition of “identifiable data” in the Final Rules, the Treasury clarified that “[a] foreign acquirer that would receive access to data that has been encrypted or anonymized, and for which the foreign acquirer has the ability to re-identify, is a relevant factor in the Committee’s risk assessment.” See Provisions Pertaining to Certain Investments in the United States by Foreign Persons, 85 Fed. Reg. 3112, 3117. This commentary by the Treasury appears to bolster the idea that U.S. high-technology businesses will need to ensure that non-expected foreign investors do not even gain *access* to sensitive personal data. See *supra* note 220 and accompanying text.

covered investment.<sup>225</sup> While this recommendation may seem harsher for startups, its bright-line nature would provide greater clarity for the VC ecosystem and also comports with the reality that CFIUS wishes to prevent Americans' sensitive personal data from falling into the wrong hands for the sake of protecting national security.<sup>226</sup>

In the event that uncertainties like these are not clarified by the Treasury with added examples and guidance, a venture capitalist or startup seeking foreign capital will have to spend even more resources intensely scrutinizing non-excepted investors during due diligence and preventing any changes in rights with non-excepted foreign investors that could lead to a mandatory filing in subsequent funding rounds.<sup>227</sup> Failure to adequately manage the risk of triggering a CFIUS filing on the front end could have disastrous effects for the venture firms and foreign investors involved in a financing when, due to lack of compliance, they find themselves triggering a costly and time-consuming mandatory filing process.<sup>228</sup> From the Committee's and

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225. Treas. Reg. § 800.211 (2020).

226. See Jehl, *supra* note 220. "Unlike the European Union, the United States has not historically placed restrictions on the transfer of personal data overseas. The new CFIUS rules, however, are the latest evidence of a gradual shift toward skepticism of foreign data access." *Id.*; see also Jeff Farrah, *Another Day, Another US Company Forced to Divest of Chinese Investors*, TECH CRUNCH (Apr. 15, 2019, 4:30 AM), <https://techcrunch.com/2019/04/15/another-day-another-u-s-company-forced-to-divest-of-chinese-investors/> (highlighting CFIUS's more aggressive focus on data as a national security threat as exemplified by its "forc[ing] Chinese investors to divest from PatientsLikeMe, a healthcare startup that claims to have millions of data points about diseases, and Grindr, the LGBTQ dating app that collects personal data"). Another example of CFIUS's willingness to patrol potential foreign acquisitions of U.S. citizens' sensitive personal data includes its investigation into ByteDance's acquisition of Musical.ly, an American company. See William Alan Reinsch & Jack Caporal, *TikTok Is Running out of Time: Understanding the CFIUS Decision and Its Implications*, CTR. FOR STRATEGIC & INT'L STUD. (Sept. 2, 2020), <https://www.csis.org/analysis/tiktok-running-out-time-understanding-cfius-decision-and-its-implications>. The Chinese-owned ByteDance is the parent company of the widely popular social media platform TikTok, and CFIUS targeted this acquisition for scrutiny for fear that U.S. citizens' sensitive personal data could be made available to the Chinese government. *Id.* Acting pursuant to the CFIUS investigation of ByteDance, President Trump issued an executive order attempting to ban TikTok "from being downloaded in app stores" and to prevent Americans from transacting with ByteDance. See Bobby Allyn, *U.S. Judge Halts Trump's TikTok Ban, the 2nd Court to Fully Block the Action*, NPR (Dec. 7, 2020, 8:36 PM), <https://www.npr.org/2020/12/07/944039053/u-s-judge-halts-trumps-tiktok-ban-the-2nd-court-to-fully-block-the-action> (noting, however, that this ban has been overturned by the federal courts for being overbroad).

227. See Kupor, *supra* note 14.

228. Tom Shoesmith et al., *Cross Border Venture Capital: US Foreign Investment Review of India Related Venture Capital Transactions*, KING & WOOD MALLESONS (Nov. 12, 2019), <https://www.kwm.com/en/us/knowledge/insights/us-foreign-investment-review-of-india-related->

Congress's perspective, however, this added uncertainty may be well worth any costs it imposes on U.S. startups or VCs.<sup>229</sup>

*B. The Treasury's Need to Strike a Balance Between Broad and Bright-Line Rules*

One of the greatest policy debates of the twenty-first century in the U.S. will likely be the dilemma between the importance of remaining economically competitive, which involves keeping capital markets unrestricted, and the equal significance of protecting national security.<sup>230</sup> This Comment has explored how invaluable VC investment as well as the innovations flowing from high-technology startups have been in producing widespread economic prosperity in the United States.<sup>231</sup> There is a strong argument, however, which has been getting louder in recent years, that allowing certain foreign investors to obtain information about critical innovations is working to undermine U.S. economic competitiveness and national security.<sup>232</sup>

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venture-capital-transactions-20191111. For example, in April 2011, an Indian technology company acquired a controlling stake in a California-based company dealing in digital identification authentication services. *Id.* The parties did not file a notice with CFIUS, prompting CFIUS to conduct “a post-closing review of the transaction and direct[] the Indian company to divest its stake in the US target company.” *Id.*

229. See Brown & Singh, *supra* note 189; *infra* Section IV.B.

230. Compare Kupor, *supra* note 14 (arguing that the U.S. should encourage foreign investment into U.S. venture funds to promote economic growth), with Brown & Singh, *supra* note 189 (addressing the connection between foreign investors in U.S. technology with national security issues). Of course, economic competitiveness and protecting national security may not be mutually exclusive. See DICK K. NANTO, CONG. RES. SERV., R41589, ECONOMICS AND NATIONAL SECURITY: ISSUES AND IMPLICATIONS FOR U.S. POLICY (2011). Preventing countries like China from using state-sponsored intellectual property theft to acquire critical technologies from U.S. companies on the forefront of innovations in areas such as defense, cybersecurity, healthcare, and artificial intelligence may serve to protect key high-tech industries in the U.S. from damaging, unfair competition. See Brown & Singh, *supra* note 189.

231. See *supra* Section II.A.

232. See Brown & Singh, *supra* note 189, at 23; see also Niall Ferguson, *Forward* to MICHAEL R. AUSLIN, ASIA'S NEW GEOPOLITICS: ESSAYS ON RESHAPING THE INDO-PACIFIC, at ix-x (2020) (juxtaposing the Obama administration's cooperative and agreeable national security stance towards China with the Trump administration's intense focus on Chinese industrial espionage and China's intent to “displace the United States in the Indo-Pacific region”); Ariel Cohen & J. Adam Ereli, *Foreign Penetration of Private Equity Endangers America*, THE HILL (Oct. 4, 2019, 4:00 PM), <https://thehill.com/opinion/cybersecurity/464356-foreign-penetration-of-private-equity-endangers-america> (arguing that “Russian and Chinese shell companies fronting for the state are methodically exploiting loopholes in our financial system to steal sensitive technologies and compromise our national security”).



This Comment's original thesis held that it was in the Treasury's interest to craft more bright-line Final Rules implementing FIRRMA to avoid foreign venture funding from going to other countries and to lower uncertainty costs for the VC ecosystem.<sup>233</sup> The coronavirus pandemic has illustrated, however, that Congress's and the Committee's focus on protecting vital innovations from countries like China is imperative.<sup>234</sup> It is in the Treasury's best interest,

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233. See Kia Kokalitcheva, *Venture Capital Industry Wants More Clarity on Foreign Investment Rules*, AXIOS (Oct. 18, 2019), <https://www.axios.com/venture-capital-cifus-foreign-investment-rules-b2fdfa6d-5b67-4405-be58-5539df83f5e5.html>. For example, one strong argument is that because of the importance of not stifling needed foreign investment in the U.S. venture capital industry, Congress and the Treasury have a vested interest in promoting rules governing CFIUS that are bright-line rather than ambiguous and open to interpretation. See H.R. 5515, 115th Cong. § 1702 (2018) (regarding CFIUS's mandate, Congress explained that "foreign investment provides substantial economic benefits to the United States, including the promotion of economic growth, productivity, competitiveness, and job creation, thereby enhancing national security"). See generally Letter from NVCA, *supra* note 199 (explaining that it is not in CFIUS's interest to handle too many "nuisance cases" as CFIUS would likely miss the important cases amidst the backlog of unimportant ones). However, because the U.S. has historically left the strategic technologies comprising its defense apparatus to the private sector for economic efficiency reasons, this has left

the United States potentially more vulnerable than other countries, because [its] national security, both defensively and offensively, is inherently more dependent on the private sector. That is, the United States relies on the private sector to protect assets of importance to national security and to develop critical capabilities that advance U.S. military and intelligence prowess.

Fagan & Williams, *supra* note 134, at 34. Furthermore:

technological change has linked trade and investment with national security in unprecedented ways. This is particularly true given that so many critical, ubiquitous technologies are 'dual-use,' i.e., they have significant military/defense and civilian applications, which has caused [both the U.S. and China] to reexamine [their respective] technological dependencies and interconnectedness with the other.

*Id.*

234. See Michael Crowley et al., *Coronavirus Drives the U.S. and China Deeper into Global Power Struggle*, N.Y. TIMES (Mar. 22, 2020), <https://www.nytimes.com/2020/03/22/us/politics/coronavirus-us-china.html>; Guy Taylor, *'Wake-Up Call': Chinese Control of U.S. Pharmaceutical Supplies Sparks Growing Concern*, WASH. TIMES (Mar. 17, 2020), <https://www.washingtontimes.com/news/2020/mar/17/china-threatens-restrict-critical-drug-exports-us/> (highlighting that "Chinese state media have raised the specter of using Beijing's pharmaceutical leverage to block critical components and supplies for dependent U.S. drug companies and send America into 'the hell of a novel coronavirus epidemic'"). The very fact that China, an authoritarian and communist regime, has threatened to withhold key medical ingredients from the U.S. during the coronavirus pandemic (a pandemic the Chinese government arguably helped to unleash on the world), serves as a monumental wake-up call and reminder that foreign investment policy should be implemented with national security as a key factor (as it was in the passage of FIRRMA). See Taylor, *supra*. Notably, even Senator Mark Warner (D-VA), who serves on the Senate Intelligence Committee and was a former venture capitalist, "says

in order to keep the U.S. as economically competitive as possible, to refine the Final Rules and make amendments and improvements to provisions that may cause uncertainty for investors.<sup>235</sup> It is *not*, however, in the Treasury's interest to narrow the scope of the Committee's jurisdiction merely for the sake of greater capital flows into U.S. businesses and VCs.<sup>236</sup> Doing so would hinder the Committee's ability to halt foreign minority investments, which may grant the investors access to material nonpublic technical information that could lead to innovation theft or sensitive personal data, thereby causing serious privacy breaches for millions of Americans.<sup>237</sup> While it is true that in the VC context such transfers of information to LPs is highly unlikely, the transfers may be more likely where there is direct investment from a non-excepted foreign investor into a U.S. startup.<sup>238</sup>

The tension between the U.S. and China, which has been building over the years and has come to a head with the coronavirus pandemic, is a stark reminder that a policy of free and unrestricted capital flows does not work with every country.<sup>239</sup> Countries with policies adverse to U.S. interests, such

he historically supported expanding economic ties with China.” Rolfe Winkler, *Chinese Cash That Powered Silicon Valley Is Suddenly Toxic*, WALL STREET J. (June 11, 2019, 10:29 AM), <https://www.wsj.com/articles/chinese-cash-is-suddenly-toxic-in-silicon-valley-following-u-s-pressure-campaign-11560263302>. He further explained: “But a few years and many, many classified briefings later, my views have changed, as the government in China has . . . . While many people in Washington understand the gravity of the threat, that’s not true across the country.” *Id.*

235. See *supra* Section IV.A.

236. See Scott Kupor, *When Innovation and Capital Go Global: On CFIUS & FIRMA*, ANDREESSEN HOROWITZ (Apr. 25, 2018), <https://a16z.com/2018/04/25/cfius-firma-global-innovation/>. While this Comment’s method of analysis is not quantitative, the heart of the strain between the venture capital community and CFIUS rests with the idea that while free and unrestricted capital flows may maximize the amount of capital that goes toward increasing U.S. innovation and intellectual competitiveness, having no barriers to foreign capital flows allows for bad foreign actors to engage in rampant industrial espionage. See *How China’s Economic Aggression Threatens the Technologies and Intellectual Property of the United States and the World*, WHITE HOUSE OFF. TRADE & MANUFACTURING POL’Y 16 (2018) [hereinafter *China’s Economic Aggression*], <https://trumpwhitehouse.archives.gov/wp-content/uploads/2018/06/FINAL-China-Technology-Report-6.18.18-PDF.pdf>.

237. See Brown & Singh, *supra* note 189, at 23 (highlighting that “[t]here are many transaction types such as joint ventures, minority investments and purchased assets from bankruptcies that are effective for transferring technology but do not result in foreign control of a U.S. entity”).

238. See Kupor, *supra* note 236 (explaining that “[l]imited partners in venture funds—whether foreign or domestic—do not get access to proprietary intellectual property, nor do they direct investments”) (emphasis omitted).

239. See *supra* note 234 and accompanying text; see also Jonathan Masters & James McBride, *Foreign Investment and U.S. National Security*, COUNCIL ON FOREIGN REL. (Aug. 28, 2018, 8:00 AM), <https://www.cfr.org/backgrounder/foreign-investment-and-us-national-security> (“In recent

as China's state-financed foreign direct investment (FDI) into key high-tech industries, state-run, cyber-enabled espionage theft, evasion of U.S. export control laws, and reverse engineering of key technologies and processes run the risk of stealing important innovations if left without oversight.<sup>240</sup> FIRRMA's expansion of CFIUS's jurisdiction fills the gap with respect to fears that some minority investments into certain critical U.S. companies could facilitate intellectual property theft, illustrating that removing the politics from the economics is, of course, a hopelessly Sisyphean task.<sup>241</sup>

#### V. BLESSING OR CURSE?: FIRRMA'S IMPACT THUS FAR

It is clear that in the Treasury's view, FIRRMA's potential for protecting national security and innovative intellectual property by vastly increasing CFIUS's foreign investment oversight far outweighs the potential uncertainty and monitoring costs<sup>242</sup> imposed on U.S. venture firms, startups, and foreign investors.<sup>243</sup> While it remains to be seen how the U.S. market for VC funding reacts to the Final Rules, it seems clear that foreign investment, particularly and predictably from China, has started to feel the heat.<sup>244</sup> For example,

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years, countries around the world have been reevaluating, and often tightening, their oversight regimes [of foreign investment]."). Interestingly, in a piece that echoes Communist Chinese Party propaganda, two Chinese academics proclaim that "the movement of globalization, which [has damaged the United States'] leadership in the world, is now out of the [United States'] control." See Xiuyan Fei & Zhenning Li, *Host States' Logic of Balance in Applying the Right to Regulate Foreign Investment Admission*, 17 U.S.-CHINA L. REV. 64, 73–74 (2020) (bizarrely and hypocritically attempting to argue that it is "illegitimate" and "irrational" for a sovereign nation to regulate its own foreign investment inflows, particularly à la FIRRMA).

240. See *China's Economic Aggression*, *supra* note 236, at 1–2.

241. See Masters & McBride, *supra* note 239. This refers to the idea that promoting a national foreign investment policy, which focuses solely on quantifiable economic gain, is obviously unrealistic. *Id.* This is likely true regardless of whether, years down the road, analysts find that the Final Rules implementing FIRRMA cost the U.S. billions of dollars more in lost capital investment than had been saved from preventing industrial espionage by way of minority investments. *Id.*

242. See *supra* notes 203, 204. "Monitoring costs" refers to the costs VCs and U.S. startups will have to bear in continuously evaluating whether or not their transactions with foreign investors are compliant with FIRRMA's provisions, especially due to § 800.213(c). See *id.*

243. See *supra* Section IV.A.

244. See Mercedes Ruehl et al., *Chinese Venture Capital Investment in US Falls to Four-Year Low*, FIN. TIMES (Oct. 2, 2019), <https://www.ft.com/content/440fecb8-e4cd-11e9-b112-9624cc9edc59>; Winkler, *supra* note 234. For example,

[s]ince [2018], amid rising U.S.-China tensions, venture firms with China ties have been dialing back their U.S. investments, structuring deals in novel ways to avoid regulators or shutting their U.S. offices. Some American venture firms are dumping their Chinese

investment by Chinese entities in U.S. startups has “fallen [in 2019] to its lowest level since 2015,” and Chinese investors are increasingly redirecting their capital toward India and Southeast Asia.<sup>245</sup> Further, “Chinese funds invested just [\$4 billion] in US companies in the first nine months of 2019. That is the smallest amount since 2015, down from nearly [\$7 billion] in the same timeframe last year.”<sup>246</sup> Due to the coronavirus pandemic, FDI flows from China into the U.S. will likely be significantly stifled.<sup>247</sup>

Chinese investment, however, has not been the only casualty of FIRRMA, with VC investment in the U.S. biotechnology sector being adversely affected as well.<sup>248</sup> Furthermore, in the fledgling space industry, FIRRMA has already been “mak[ing] it more difficult for space companies to accept money from any private foreign investors.”<sup>249</sup> Entrepreneurs and VCs have complained that FIRRMA has had a negative effect on funding rounds and is forcing some to reject foreign investment altogether or only take it from close U.S. allies.<sup>250</sup>

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limited partners or walling them off with special structures. And some U.S. startups that have taken significant Chinese money are keeping the investments quiet or trying to push their Chinese investors out to avoid scrutiny.

Winkler, *supra* note 234.

245. See Ruehl et al., *supra* note 244.

246. *Id.*

247. See Thilo Hanemann et al., *Two-Way Street—US-China Investment Trends—2020 Update*, RHODIUM GROUP (May 11, 2020), <https://rhg.com/research/two-way-street-us-china-investment-trends-2020-update/> (explaining that “China’s outbound FDI to the US came to an almost complete stop in 1Q 2020”). Of course, tracking FDI flows is simply a rough gauge for the amount of foreign investment flows from China into the U.S. venture capital ecosystem. *Id.* Interestingly, the U.S. venture capital ecosystem generally fared quite well throughout the pandemic-ridden year of 2020, with “VC dealmaking remain[ing] extremely resilient throughout the pandemic.” See *2020 Pitchbook—NVCA Venture Monitor*, 3Q PITCHBOOK 1, 5 (2020) (noting that in 2020, deal counts have “seen a divergence with a slowdown at the earliest stages and an acceleration at the late stage in 2020 on the back of VC megadeals . . . and larger deals in general”).

248. See Dan Stanton, *Biotech VC Down 20% in US as Policies Drive Away Foreign Investors*, *BIO Says*, XCONOMY (Nov. 29, 2019), <https://xconomy.com/national/2019/11/29/biotech-vc-down-20-in-us-as-policies-drive-away-foreign-investors-bio/>. The Biotechnology Innovation Organization explained that venture capital investment in the biotechnology sector had decreased by 20% between 2018 and 2019 based on their preliminary numbers at the time. *Id.* Moreover, the group saw that as investment in the U.S. biotechnology sector had decreased, such investment in Europe was seen increasing, potentially signaling that FIRRMA is driving away venture capital dollars to other, less uncertain markets. *Id.*

249. See Debra Werner, *The Torture of CFUS: A 2018 Law Is Changing the Way Space Industry Startups Raise Money*, *SPACE NEWS* (Nov. 27, 2019), <https://spacenews.com/the-torture-of-cfus-a-2018-law-is-changing-the-way-space-industry-startups-raise-money/>.

250. *Id.* VCs and entrepreneurs in the space industry as well as analysts who have followed FIRRMA’s development have noted that they are not only wary of having one of their transactions

Because these difficulties are already beginning to appear, it is crucial that the Treasury continue to engage with the VC community and other relevant stakeholders in order to provide more detailed guidance on how certain provisions may be applied (such as those relating to material nonpublic technical information and how the investment fund exception could operate in practice).<sup>251</sup>

Another notable development from FIRRMA's CFIUS reform is the responses from other countries taking similar actions.<sup>252</sup> For instance, Canada and Germany blocked threatening Chinese acquisitions in 2018.<sup>253</sup> Additionally, in 2019, the European Commission "approved a block-wide mechanism for screening FDI to build on national review mechanisms already in place in 12 member states."<sup>254</sup> This increase in foreign investment oversight around the world caused by FIRRMA's passage even pushed China to retaliate, "propos[ing] new draft regulations to expand the foreign investments covered under its national security review process" in 2018.<sup>255</sup> One legacy of FIRRMA may therefore be a tightening of foreign investment controls all across the developed world with scrutiny dictated by the geopolitical landscape of the day.<sup>256</sup> But do we want foreign investment policy guided primarily by geopolitical and economic power struggles, or should our policy be guided mostly by the importance of funding the next generation of innovative startups?<sup>257</sup> Congress's view on this point, encapsulated by FIRRMA's passage, is sensible: maintaining an open investment policy is a cornerstone of the strength of the U.S. economy, but the national security risks inherent in high-tech espionage must be taken seriously.<sup>258</sup> Only time will tell whether the Final Rules implementing

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rejected by CFIUS, but are also unnerved by the thought of having to exhaust the time and money dealing with a potential filing and review process. *Id.*

251. *See supra* notes 199, 210 and accompanying text.

252. *See* JAMES K. JACKSON & CATHLEEN D. CIMINO-ISAACS, CONG. RES. SERV., IF10952, CFIUS REFORM: FOREIGN INVESTMENT NATIONAL SECURITY REVIEWS 2 (2019).

253. *Id.*

254. *Id.*

255. *Id.*

256. *See Why Tech Companies Now Sit at the Crossroads of Business and Politics*, ARGO ASSOCIATES (Aug. 27, 2018), <https://www.argoassociates.com/articles/why-tech-companies-now-sit-at-the-crossroads-of-business-and-politics/>.

257. *See* Kupor, *supra* note 236 and accompanying text. *But see supra* Section IV.B.

258. *See* H.R. 5515, 115th Cong. § 1702 (2018). Congress noted the vast importance of foreign investment in the U.S. economy when it highlighted that as of 2016, "12,000,000 United States workers, equivalent to 8.5 percent of the labor force, [had] jobs resulting from foreign investment."

FIRRMA strike this balance sufficiently.<sup>259</sup>

## VI. CONCLUSION

Venture capital investment has been crucial for advancing innovation, productivity, and prosperity in the U.S. for decades.<sup>260</sup> Industrial espionage of high-tech innovations by geopolitical competitors like China, however, has proven to be costly to the U.S. in terms of its technological competitive advantage.<sup>261</sup> It appears certain that the Final Rules implementing FIRRMA will accomplish the goal of policing transfers of material nonpublic technical information as well as sensitive personal data from important U.S. businesses to foreign investors, thereby reducing potential technological espionage.<sup>262</sup> This benefit will not come without a cost, however, as the Final Rules now force VCs and high-tech startups to be on constant alert regarding potential influence exerted by foreign investors on advisory boards, guarding against *any* information that is seemingly technical from being released to foreign investors, and monitoring for potential changes in rights of foreign investors in subsequent funding rounds that could trigger a costly mandatory filing.<sup>263</sup> Whether FIRRMA will prove to be an economic winner or loser overall for the U.S. may ultimately turn on the extent to which foreign capital is withheld or driven away from VCs and high-tech startups, as well as the uncertainty and monitoring costs imposed on the U.S. VC ecosystem.<sup>264</sup> This Comment reiterates the point that many forget, however, that economic and national security policies are inextricably intertwined.<sup>265</sup> The VC ecosystem will

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*Id.* Further, Congress highlighted the tens of billions of dollars in research and development spending as well as the hundreds of billions in value added to the economy due to foreign-owned affiliates in the U.S. *Id.* Congress somewhat vaguely, however, explained that “the national security landscape has shifted in recent years, and so has the nature of the investments that pose the greatest potential risk to national security.” *Id.*

259. *Id.*

260. *See supra* Section II.A.

261. *See* Schleifer, *supra* note 127.

262. *See supra* Section III.A.

263. *See supra* Section IV.A.

264. *See supra* Section V.

265. *See supra* Section IV.B.

unfortunately have to accept FIRRMA's disruption, as well as other future disruptions like it, as the new normal for decades to come.<sup>266</sup>

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266. *See supra* Section IV.B.

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