April 11, 2018

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

The Honorable Andy Barr
Chairman
Subcomm. on Monetary Policy and Trade
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

The Honorable Gwen Moore
Ranking Member
Subcomm. on Monetary Policy and Trade
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United States House of Representatives
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Chairman Hensarling, Ranking Member Waters, Chairman Barr, and Ranking Member Moore:

On behalf of our nation's venture capital investors and the entrepreneurs they support, I write to share our views ahead of your committee's hearing on "H.R. 4311, the Foreign Investment Risk Review Modernization Act (FIRRMA) of 2017." The venture industry believes FIRRMA is well-intentioned legislation that deals with a serious issue. However, key changes should be made to FIRRMA before the committee proceeds, otherwise the legislation could cause unintended consequences that chill investment in high-growth startups.

<u>Challenges to American entrepreneurial leadership</u>

For many years, the United States has been the worldwide leader in startup activity, having produced leading health care and technology companies that improve our lives, cure the deadliest diseases, and provide scientific advancement. Our country has benefitted significantly from robust entrepreneurial activity, with one study finding "that without startups, there would be *no* net job growth in the U.S. economy."[1]

[1] "The Importance of Startups in Job Creation and Job Destruction," Kauffman Foundation Research Series: Firm Foundation and Economic Growth," (July 2010), *available at* http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2010/07/firm_formation_importance_of_startups.pdf (Emphasis added).

Other countries have witnessed the benefits entrepreneurship has brought the United States and have sought startup ecosystems of their own. Startup activity has become a global competition, with foreign countries aggressively pursuing the world's top talent and risk-capital to build new companies. As a result, the U.S. has seen its share of global venture capital dollars precipitously drop from 90% in 1990 to 53% last year.[2] China attracted $42 billion in venture investment in 2017 and is now the second largest destination in the world for venture capital. In 2017, seven out of the ten largest venture deals in the world—including the top three—occurred in China.[3]

The reality is investors now have a world of choices on where to deploy capital. Policymakers must ensure the U.S. remains the most attractive destination in the world for new company formation so we can continue to experience the benefits of entrepreneurship. If we fail in this regard, other countries stand ready to take advantage of obstacles we put in place to the free flow of risk capital. It is therefore imperative that as FIRRMA is considered that policymakers are sensitive to its impact on investment in startups.

Structure of venture funds mitigates concerns over Chinese investment

A major motivation of FIRRMA is concern that foreign entities use minority investments into U.S. startups to gain access to critical technology. The venture capital industry shares the goal of this committee and FIRRMA's authors to protect U.S. innovation and ensure that U.S. critical technology is not used to harm our competitiveness or security. It is important to understand, however, that the structure of venture capital funds effectively protects sensitive information of startups from disclosure to investors into the fund. Therefore, it is imperative that FIRRMA ensure that investments into venture funds be treated as passive investments, and therefore not be a "covered transaction," under the legislation.

The relationship between the investors in venture capital funds, termed limited partners (LPs), and the individuals charged with managing the fund and making investments, termed general partners (GPs) is governed by a limited partnership agreement (LPA). The LPA defines not only the economic relationship between the parties, but also the nature of involvement of the LPs in the investment entity. By design, the LPs have very limited rights in the ongoing fund entity – they are expressly entitled to defined economics resulting from the investments and to regular financial reporting from the fund.

It is important to note that LPs have *no* say in investment decisions and *no* ability to garner portfolio company information other than at the discretion of the GPs. In addition, the LPA contains a confidentiality provision that binds the LP to maintain in confidence all such information as provided by the GP. Therefore, as a matter of course, information disclosure to LPs is minimal and largely related to valuation and accounting-related information to ensure that the LP understands its current economic position in the fund.

In addition, in many cases a venture capitalist will sit on the board of directors of the company in which he or she invests and, as a result, will also owe a duty of confidentiality directly to the

[2] Pitchbook – NVCA data.
[3] Id.

shareholders of those companies. Thus, to the extent a venture capitalist were aware of proprietary technology in use or being developed by the company, he or she would not be in a position to share that with LPs. In fact, most LPAs contain an express provision in which LPs acknowledge that GPs may have independent fiduciary duties to their companies such that they may be restricted in being able to share any information with LPs.

As a matter of common practice in the industry, most GPs provide LPs with quarterly financial reports of the fund's performance and, in some cases, investment letters that highlight interesting trends and/or new investments on which the GP may be focused. However, in no case will those updates include details on intellectual property or other proprietary information, as that might violate the GP's duties to the company. Importantly, it would also be against the financial self-interest of the GP to risk disclosing information that might leak to the marketplace and risk impairing the financial value of the asset.

Key changes should be made to protect investment into U.S. startups

FIRRMA expands the mandate of the Committee on Foreign Investment in the United States (CFIUS) to review minority investments into U.S. critical technology companies, unless the investment is a passive investment. Key changes should be made to FIRRMA that maintain the intent of the bill but mitigate damage to U.S. startups that need capital to grow. These changes are necessary because in recent years foreign entities have become an increasingly important component of startup financing, both serving as direct investors into U.S. companies and as LPs in venture funds that go on to invest in startups. American startups need capital to grow and hire and have benefitted significantly from foreign investment that supplements domestic investment. If critical foreign investment were to dry up, it is unclear how that capital would be replaced.

FIRRMA should be amended to reflect true passivity

FIRRMA provides that a "covered transaction" is, *inter alia*, an "investment (other than a passive investment) by a foreign person in any United States critical technology company or United States critical infrastructure company, subject to regulations prescribed under subparagraph (c)." [4] The legislation recognizes that passive investments into startups do not create national security concerns because an investor does not have access to sensitive information that is the concern of FIRRMA.

Unfortunately, the passive investment exemption is narrowly drafted and will cause harmless investment into U.S. companies to be picked up by FIRRMA, thus causing delay for the company raising capital; needless cost and burden to the investor; and distraction for CFIUS from the true security concerns. For example, the passive investment exemption requires that a foreign person not have "access to any nontechnical information in the possession of the United States business that is not available to all investors."[5] This is an unnecessarily strict prohibition to keep sensitive technological information out of the hands of foreign investors, and will have the effect of taking truly passive investors outside the exemption. As discussed above, LPs in venture funds—whether foreign or domestic—generally receive valuation and accounting-related

[4] *See* FIRRMA, Sec. 3(a)(5)(B)(iii).
[5] *See* FIRRMA, Sec. 3 (a)(5)(D).

information about portfolio companies. This information is not publicly available and could have the unfortunate result of pushing foreign LPs outside the exemption when that information provides no technological benefit to any foreign actor.

Furthermore, foreign strategic investors have become an important financing option for U.S. startups and often co-invest alongside U.S. venture investors. The prohibition on access to nontechnical information could similarly push these investors outside the exemption. This would be inappropriate because foreign strategic investors making direct investments frequently gain access to nontechnical information about a company when considering an investment, but that nontechnical information is harmless and should not affect a determination about whether the investment is passive.

FIRRMA should exempt a broader universe of U.S. allies

FIRRMA grants CFIUS the authority to exempt countries from the definition of a covered transaction and directs CFIUS to consider "whether the United States has in effect with that country a mutual defense treaty," among other factors.[6] Rather than apply FIRRMA on a global basis and then exempt certain countries, FIRRMA would benefit from *only* applying to certain countries with known problems. The benefit of this formulation is that CFIUS would focus on investments from a dedicated universe of problematic countries and not waste time and resources on minority investments from U.S. allies.

Should FIRRMA continue to apply on a global basis, FIRRMA's guidance that CFIUS may exempt countries "with a mutual defense treaty" should be broadened to capture a wider universe of U.S. strategic partners that ought to be exempted from the covered transaction definition. For example, some U.S. strategic partners in Asia and the Middle East may not qualify under the current exemption but are nonetheless U.S. allies and important sources of funding for U.S. startups. In addition, a U.S. ally like Switzerland will likely not meet the current exemption due to the lack of a treaty, but is certainly meritorious of an exemption and is a key player in venture and startup investing. This is especially the case in health care, which is capital intensive and in need of considerable resources to bring a new prescription drug or device to market.

FIRRMA should provide better direction to CFIUS on the meaning of critical technology

FIRRMA provides CFIUS jurisdiction over foreign investments into "critical technologies," which it defines as "technology, components, or technology items that are essential or could be essential to national security, identified for purposes of this section pursuant to regulations prescribed by [CFIUS]."[7] In addition, FIRRMA sets forth a variety of U.S. government product lists that are included in the definition.

It is important to understand that we are fast approaching a world where technologies like artificial intelligence (AI) and machine learning (ML) will be horizontal technologies that are used in nearly every product and service. Therefore, if FIRRMA applies even to incidental use of technologies like AI/ML by a U.S. company then FIRRMA's impact may apply more

[6] *See* FIRRMA, Section 3(a)(5)(C)(ii).
[7] *See* FIRRMA, Section 3(a)(8).

generally than is intended or prudent. For this reason, FIRRMA should cabin off the "critical technologies" definition, lest it provide an incredibly broad mandate to CFIUS.

FIRRMA should not stifle foreign strategic investors that have become a key aspect of startup financing

A growing and important component of startup financing is participation by so-called foreign strategic investors, like investment arms of multinational corporations. These investors are increasingly providing capital to U.S. startups alongside U.S. venture funds as co-investors, especially in later-stage deals where the amount of capital raised by the company is significantly larger than would be raised by an early-stage company. These foreign strategic investors are important to the entrepreneurial ecosystem because frequently when a startup is raising capital there will be multiple entities that will participate in the round as co-investors to ensure the startup is able to raise the capital it requires.

It would be an unfortunate outcome if the foreign co-investor of a U.S. venture fund needed approval from CFIUS to participate in an investment round, as that would complicate and slow the round *even* in situations where the foreign investor is taking a minority stake in a round for a minority stake of the company. For example, imagine a U.S. critical technology startup that is raising capital from four entities, three of which are U.S. venture funds and the fourth of which is a foreign strategic investor. In that round, the company sells 20 percent of the company for $50 million and the foreign investor takes 25 percent of the round, resulting in a 5 percent ownership interest in the company. With a 5 percent ownership stake, the foreign strategic investor will not have access to sensitive information that is the concern of FIRRMA, but it may need to file preemptively with CFIUS out of caution to determine whether the investment is acceptable. Ideally, the foreign strategic investor would clearly meet FIRRMA's passive investment test and be assured the investment was acceptable, but as described above that test is very narrow and does not reflect true passivity. This scenario could result in a U.S. startup missing out on key investment capital as the company seeks to grow. As a practical matter, investment rounds are very competitive and decisions are often made in a matter of weeks if not days. Thus, filing requirements (or uncertainty) that would jeopardize this timeline are likely to mean that the investors will be prohibited outright from participating in the investment opportunity.

To avoid this situation, FIRRMA should specify that an investment is *not* a covered transaction if a foreign strategic investor takes a *de minimis* stake in the startup (such as in the hypothetical above), as in that scenario the foreign strategic investor is a *de facto* passive investor but might fear it does not meet the tightly drafted passive investment text.

We appreciate the committee's attention to this important topic. The venture industry stands ready to work with the committee and FIRRMA's authors to improve the legislation to ensure harm is not done to American startups as they grow and prosper.

Sincerely,

Bobby Franklin

Bobby Franklin
President and CEO