



August 2, 2024

Via www.regulations.gov

Meena R. Sharma
Director, Office of Investment Security Policy and International Relations
U.S. Department of the Treasury
1500 Pennsylvania Avenue
Washington, DC 20220

Re: National Venture Capital Association Comments on Notice of Proposed Rulemaking RIN 1505-AC82, Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern (89 FR 55846) (the “NPRM”)

Dear Ms. Sharma:

The National Venture Capital Association (“NVCA”) appreciates this further opportunity to submit comments on the NPRM, which proposes the implementation of a regime that would restrict U.S. capital outflows to certain China-related parties in certain specific industries. Rather than reiterate its interest in this proceeding, NVCA refers the Department of the Treasury (“Treasury”) to NVCA’s comments on the Advance Notice of Proposed Rulemaking (“ANPRM”) in this proceeding for details on the role its members play in the U.S. innovation economy, and also its purposes in submitting both those comments and now these further comments on the NPRM (the “Comments”). These Comments expand upon a handful of key points from NVCA’s ANPRM comments and also flag a couple of changes in the NPRM that may impact the venture investing environment.

As a threshold matter, NVCA commends Treasury for some of the clarifications and amendments made in the NPRM that help ameliorate certain concerns that were present at the ANPRM stage. For example, NVCA appreciates Treasury’s inclusion of clearer language around the application of the “knowingly directing” test in the outbound rules. The NPRM includes language suggesting that the rule is really a restriction on senior decisionmakers and others that “substantially participate” in investment decisions at foreign companies and funds – i.e., officers, directors, voting GPs, etc. – and more specifically about their roles in actions like votes that have a direct role in moving the fund forward with that investment. Keeping and further clarifying this test will be critical to ensuring that U.S. funds and their personnel are not isolated from the larger global investing community, ending up unable to collaborate and co-invest with European and other foreign funds.

With that said, NVCA’s two overarching (and interconnected) concerns with respect to the ANPRM remain quite salient in the NPRM:

- **First**, if the rules are promulgated on the terms proposed by the NPRM, they are likely to create significant cost in cases where that cost brings effectively no national security benefit.

- **Second**, many of the NPRM proposals and definitions still do not provide the requisite clarity to enable investors to understand which investments should be notified or must be prohibited.

With respect to the first concern, the NPRM's proposed rules will impose a significant diligence burden on U.S. venture investments across the board. Treasury has indicated that an investor's liability for violations will depend in significant part on the strength of that party's diligence. Specifically, the NPRM ties many of the notification/prohibition obligations in the rules to the question of whether the U.S. person "knows" at the time of the transaction that the target is or is in certain ways specifically related to a covered foreign person. In § 850.104, Treasury notes that it will construe knowledge to exist "based on information a U.S. person had or could have had through a reasonable and diligent inquiry," including diligence inquiries directed to the counterparty, representations obtained, searches of public information, and so on.

NVCA's core concern is that Treasury's definitions are broad enough to require at least some diligence to be performed in the context of *every venture investment made by a U.S. investor*. Because even a U.S. company can be a "covered foreign person" by virtue of having substantial Chinese ownership (under § 850.209 and § 850.221), merely checking the place of legal organization of a target will not suffice. Similarly, because AI has become part of a significant portion of many startups' strategies, and because the definitions of notifiable and prohibited transactions involving AI (under § 850.217 and § 850.224) are open-ended, merely taking a quick look at an investor presentation to evaluate the target's primary mission will also not provide enough information to rule out applicability of the NPRM's rules. Accordingly, U.S. venture investors will likely need to investigate either a target company's foreign investor base, the specifics of its technology, or both, for every investment they make.

The overall impact of the rules, then, will be to add a cost – perhaps only a few thousand dollars in many cases, but undoubtedly much higher in some – to each of the fifteen thousand or so venture investments made in the United States. The Treasury estimates that the rules will affect just a few hundred transactions annually, with direct costs in the range of less than \$10 million annually, are woefully low. Conservatively, NVCA anticipates that impact will amount to at least \$100M – and potentially hundreds of millions or billions of dollars – spent on diligence and legal fees rather than on the development of the next generation of semiconductors, fusion equipment, or autonomous vehicles. For companies in the technology spaces the NPRM directly addresses – e.g., quantum computing or AI – the expenses will be higher, as investors will want to carefully examine their cap tables to confirm no Chinese presence. That cost will be borne by the companies. In other words, these rules will take money away from the development in the United States of critical technologies that themselves advance U.S. national security.

To explain why this is true, we turn to the second concern – i.e., the absence of clear definitions for some of the key terms in the regulations. For example, as noted in NVCA's comments on the ANPRM, the definition of "person of a country of concern" in § 850.221 contains a number of vague concepts – e.g., what it means for an entity to "act[] for or on behalf of the government" of a country or what constitutes "the power to direct or cause the direction of the management and policies" of a company. The NPRM has not further defined these concepts or offered additional examples. In practice, U.S. investors in a given venture-backed company will not know the identities and background of the prior investors that populate their prospective investee company's cap table. Further, these U.S. investors will have no direct contractual relationship with those prior investors. As a result, these U.S. investors often will have limited ability to engage in many of the diligence activities discussed above to establish the absence of "knowledge" as to how many, if any, of a company's prior investors could potentially have a relationship with Chinese parties or the Chinese government.

As another example, the set of notifiable AI-related transactions includes investments into any AI product "[d]esigned to be used for any ... mass-surveillance end use (e.g., through mining text, audio, or video; image recognition; location tracking; or surreptitious listening devices)." See § 850.217. However, many AI products in all kinds of fields ranging from medical imaging to consumer chatbot help services use the input from their users

as a dataset to then train and improve the next generation of their product. Does the mass collection of these user text inputs or images constitute “mass surveillance”? The NPRM is not clear on the subject. As a result, many U.S. investors into AI companies will need to tackle these thorny questions in order to be comfortable enough to invest in those enterprises. Again, the company, rather than the investor, is likely to have the detailed knowledge needed to get comfortable confirming something is or is not “mass surveillance.”

In practice, these unclear definitions will mean that investors will push the questions over to the company side. Companies will be required to provide representations that they have done the work to assess their investors, their technology, or both, to confirm that there are insufficient China links or that the technology is out of scope (or both). As a result, the costs of determining the presence of factors of concern will be passed through to the startup businesses, further reducing the resources available to those businesses to engage in R&D and advance U.S. innovation.

NVCA appreciates that Treasury’s intention is to create a narrowly tailored regime – in the words of the National Security Advisor, a small yard but a high fence – that focuses specifically on investments into truly China-related businesses working in a small number of areas of great concern. NVCA supports this mission wholeheartedly. By clarifying some of the aforementioned definitions – perhaps in the manner suggested in NVCA’s prior ANPRM comments, or at a minimum through the provision of additional examples in the final regulations – Treasury could help to reduce the cost burden that will ultimately be borne by U.S. startups and their investors.

Finally, NVCA also wishes to briefly flag once more some of the more comprehensive solutions discussed in its ANPRM comments:

- Establishing a passivity exception for passive venture investment – along similar lines to the version proposed in Alternate 1 for paragraph (a)(1)(iii) in the NPRM for LP investors – would be a very valuable step. Right now, the NPRM suggests that LPs are uniquely in the position of being minority investors possessing limited ability to impact target company behavior. This ignores the fact that many – possibly even most – venture investors are in the same position. For example, a U.S. person limited partner that owns 2% of a foreign private equity fund that buys 100% of a “covered foreign person” would be considered a party to a permissible excepted transaction under the Alternate 1 rule as long as that LP has limited say in the management of the covered foreign person. However, a U.S. venture capital fund that procures a 2% stake in an identical company – usually with the same limited level of influence over the target business, given the size of the fund’s stake – would not be similarly protected by the exception. Alternate 2 presents the same concern, treating a venture investment below a certain size differently than an LP investment. A “passive investment” exception that treats all passive investment similarly and does not arbitrarily privilege LP status would significantly reduce the impact of the new rules on the U.S. innovation ecosystem. It would also remove incentives for U.S. LP capital to flow to funds outside the U.S. (and thus outside Treasury’s purview).
- Alternatively, establishing model representations from Treasury to use in diligence contexts – with a presumption that obtaining those representations constitutes sufficient inquiry – would also significantly reduce the burden on startups and investors.

In sum: NVCA supports the stated concerns underlying the NPRM. Most NVCA members are U.S. venture capital funds managed by U.S. persons and would never seek to accelerate the progress of military development in countries of concern. However, Treasury should adjust the final rules to ensure that the unintentional drag on investments in the U.S. – most particularly investments in sectors in which the rules are supposed to establish a U.S. technical advantage – are not significantly hindered.