



SEPTEMBER 10, 2023

Many VCs may be underestimating the full impact of outbound rule

The vast majority of venture capital firms say they will not be impacted much by the Treasury's proposed rule on outbound investment in China. That's according to a recent survey by Foreign Investment Watch; only 16 percent of respondents said they would be impacted "significantly" by the proposal. Most had not even taken the time to read the proposed rule yet.

WHAT HAPPENED

As most Foreign Investment Watch readers know, the Treasury Department has [proposed a rule](#) that would regulate U.S. outbound investment in China. The proposal, which was unveiled shortly after President Biden issued an [Executive Order](#) on the matter, would basically do two things:

1. **Prohibitions** – Ban certain U.S. persons



Cassidy Levy Kent partner Ulrika Swanson was not surprised by the survey results. "It was known that these restrictions were coming," she said, "so there had already been some distancing from China prior to the announcement of the outbound investment program."

from engaging in transactions involving “certain technologies and products” that pose a “particularly acute” national security threat to the United States;

2. Notification – Require U.S. persons to notify Treasury of other transactions involving certain technologies and products that may contribute to the threat to the national security of the United States.

To understand the potential impact of the proposal, Foreign Investment Watch conducted a survey of venture capital firms, private equity firms, corporations – including corporate venture capital or “CVC” groups – and institutional investors such as pension funds that might be LPs in other funds.

The survey was conducted during the last two weeks in August. The majority of responses (71.4 percent) came from U.S.-based venture capital firms. Other responses came from corporations (14.3 percent) and institutional investors (10.7 percent). Another 3.6 percent of participants were at law firms or other parties, but they were not qualified to participate and their responses were not included in results.

LITTLE IMPACT?

According to the survey, the vast majority of respondents said they would not be significantly impacted by the proposed rule. When asked to what extent the proposal might impact their firm, 68.1 percent said “not much at all.”

Only 16 percent of respondents said they would be impacted “significantly”; 8 percent said they would be impacted somewhat.

The results were similar when we filtered only by venture capital firms, and eliminated other responses: Only one-quarter

of VC firms (24.6 percent) said they would be impacted “somewhat” or “significantly.”

There are several possible reasons for the low numbers.

First, most VC firms don’t invest in regions impacted by the proposed rule, and hence assumed they would not be impacted. “We don’t invest in China or adversarial countries’ companies,” wrote one respondent. “This is not relevant to us as we do not invest in Chinese companies,” said another. More on this point later.

Second, those that do invest in China may have already taken action to minimize exposure. According to Porter Wright partner Matthew Lapin, most venture capital and private equity firms “have already substantially reduced their direct investments in China over the past few years,” particularly in sectors that were likely to be impacted by the E.O. “My impression is that the industry views itself as having already significantly ‘de-risked’ in this regard,” he says.

Tyler McGaughey, a partner at Winston & Strawn, agrees, noting that firms “appear to have already taken steps to minimize the impact of the regulations.”

“It was known that these restrictions were coming,” adds Ulrika Swanson, a partner at Cassidy Levy Kent, “so there had already



“Statistics indicate that VC and PE firms have already substantially reduced their direct investments in China over the past few years, particularly in the technology sector,” said Porter Wright partner Matthew Lapin. “My impression is that the industry views itself as having already significantly ‘de-risked’ in this regard.”

been some distancing from China prior to the announcement of the outbound investment program.”

Third, the outbound proposal was specifically drafted so that it would not have a major impact on firms doing business in China, so survey respondents likely took that to heart. “It’s intended to be tightly focused on investments in a narrow set of cutting-edge technologies that could have an impact on national security,” says McGaughey at Winston & Strawn. “For investment firms that are not investing in those specific technologies, the outbound investment program shouldn’t have a large impact.”

“The responses are not surprising,” adds Akerman partner Matthew Goldstein. “The focus on China and narrow scope of sectors targeted by the Executive Order seem to make it less of a concern to investors than other priorities.”

Step toe & Johnson partner David Stetson agrees, noting that the Biden administration’s “small yard, high fence” approach means that “a majority of U.S. firms appear to believe their investments involving China will not ultimately fall within that small yard.”

However, Stetson warns that some survey respondents may be focused on the “ultimate business or commercial impact,” rather than on the impact to the investment diligence processes. “Of the



Winston & Strawn partner Tyler McGaughey was not surprised by the survey results, noting that the Biden administration “has been signaling for a long time” that the outbound investment program was likely to happen. “Some of the bigger investment firms have likely already lobbied the administration aggressively to push back on earlier proposals to ensure that the regulations would not have a major impact on their investment activities,” he says.

U.S. private equity and venture capital firms making investments involving China,” he says, “a sizable number will probably need to refine their diligence processes once the outbound investment rules are finalized” to assess whether a transaction is prohibited or notifiable under the ANPRM.

Goodwin Procter partner Amy Josselyn agrees that the proposed outbound regime, as currently articulated, would affect a “relatively narrow set of transactions,” but also warns that the ANPRM “could have a substantial impact on the transactions it does affect.”

Goldstein at Akerman also believes the impact on firms “will likely be greater than the responses suggest, particularly because many folks overlook the potential impacts on investments outside of China.”

UNAWARE OF SCOPE

Experts seem to agree with Goldstein, noting that respondents might actually be underestimating the impact of the proposal, as they likely don’t understand the full scope of the ANPRM.

“There’s a good chance that some firms have not studied the regulations yet,” says McGaughey, who previously was Deputy Assistant Secretary for Investment Security at Treasury. That’s largely because the outbound investment program likely won’t go into effect until sometime next year, he says.

“At this early stage,” agrees Stetson, “some of the survey respondents may just be in a ‘wait and see’ posture.” That approach, says Stetson, may be bolstered by statements from the U.S. government “that they intend for the outbound investment restrictions to be narrowly tailored.”

The data actually support the hypothesis of McGaughey and Stetson: Forty percent of survey respondents said their firm hadn't yet reviewed the [Executive Order](#) or [Advanced Notice of Proposed Rulemaking](#) by Treasury.



According to Steptoe & Johnson partner David Stetson, the Biden administration has said that the rules are intended to reflect a “small yard, high fence” approach. “So it is not surprising that a majority of U.S. firms appear to believe their investments involving China will not ultimately fall within that small yard.”

Since they haven't read the documents, respondents might not understand that — as we [covered](#) before Labor Day — the proposed rule could impact investments in any country, even the United States, under certain circumstances.

“It's not only possible but likely” that respondents don't fully understand the potential impact of the proposal, says Mira Ricardel of The Chertoff Group.

“These restrictions don't just apply to direct investments from the United States to China,” says Swanson at CLK, “and are likely broader than some firms are anticipating.”

Jossley at Goodwin Procter agrees, noting that “the definitions of ‘U.S. person’ and ‘person of a country of concern’ may be broader than some survey respondents appreciate.”

“I think this is the key missing piece,” emphasizes Lapin at Porter Wright. “The outbound screening program has the potential to impact a much broader set of transactions beyond direct investments in China,” he says, including potentially “a wide

range of entities where there is beneficial ownership or control by parties in China.”

“You have to study the proposed definitions in the ANPRM pretty carefully to fully appreciate how the outbound investment regime could apply even if the investor is not located in the U.S. and the target company is not located in China,” says McGaughey at Winston & Strawn. He adds that investors might not yet fully appreciate how U.S. investors “will need to perform some due diligence on most of their outbound investments, even if the investments do not seem like they would be captured by the outbound investment program.”

For example, says McGaughey, while the proposed outbound regime is not retroactive, investment firms that want to do follow-on investments in the same target companies are “going to need to perform due diligence on those targets to determine whether the outbound investment program applies going forward.”

Stetson at Steptoe hammers this point home, noting that the ANPRM specifically asks for feedback on how follow-on investments should be treated. “Firms that anticipate follow-ons to existing investments involving China may want to assess those investments and submit comments — supported by information and examples — on how



Mira Ricardel of The Chertoff Group says it is increasingly important that companies understand fully their exposure in China. “As the trend line clearly is leading toward greater restrictions on investments in China,” she says, “more firms will have to conduct audits if for no other reason than other

the rules should treat follow-ons,” he says.

investors or shareholders will demand to know what potential risks may be associated with those investments.”

GETTING PREPARED

According to the survey, only 12 percent of respondents said their firm had conducted an audit or review of existing investments in China to determine which might be considered “covered transactions” in technologies or products impacted by the proposed rule. Another 8 percent were considering such an audit or review.

As would be expected, for firms that said they would be impacted “somewhat” or “significantly” by the rule, the number of audits or reviews conducted jumped to 66.7 percent.

As we [reported a year ago](#), some anticipated that the imposition of an outbound regime might create a market for “national security audits.” These reviews would establish processes to vet both existing portfolio companies and potential investments with multiple national security lenses.

Experts were not surprised that most firms hadn’t yet conducted these reviews. “As the specific parameters of the outbound screening program are still being crafted, I’m not surprised that VC and PE firms are still getting up to speed on conducting audits or enhanced due diligence in this regard,” said Lapin at Porter Wright. And while Lapin anticipates firms will increasingly undertake such reviews, he notes it often takes a catalyst to impel action. “As with CFIUS or economic sanctions enforcement,” he says, “it often takes a high-profile transaction that is blocked or investigated for large numbers of firms to devote resources to audits or enhanced due diligence.”

“Venture capital and private equity firms might conduct deeper-dive internal investigations and audits to help themselves remain

compliant with this rule, should it be adopted,” says Taft partner Sohan Dasgupta. “Sometimes,” he adds, “exercising an abundance of caution can be appropriate, especially where gratuitous risk is not advisable.”

Dasgupta says it’s possible that, going forward, other firms may conduct such internal investigations, “particularly if regulatory data points and evidence so counsel.”

Crowell & Moring partner Jason Prince agrees. “It’s also important to remember that these sorts of national security-focused programs have a long track record of expanding, rather than retracting, over time,” says

Prince. “There’s a relatively high chance that the outbound investment program’s scope will eventually grow in a way that sweeps in more firms and their investments.”

Ricardel at The Chertoff Group believes firms should start the process now. “It’s a risky move to refrain from auditing current and planned investments until a proposed rule such as this is finalized.”

ACTION ITEMS

For now, experts recommend that transaction parties comment on the Treasury Department’s proposed rule. “I’ve been advising clients that invest in both the target technology sectors, as well



Crowell & Moring partner Jason Prince says that, as firms and their outside counsel continue to digest the ANPRM’s potential scope and impact, “I believe more firms will develop and conduct audits or reviews of their existing and contemplated investments in China.”

as those in other high-tech sectors ... to provide comments on the potential impact of the ANPRM and start assessing their potential exposure,” says Lapin, “particularly with respect to investments in the targeted industry sectors in countries that may have significant economic ties to China.”

McGaughey at Winston & Strawn agrees, noting that it is a good time to engage with Treasury and reflect on how definitions in the ANPRM could apply to their business activities, “and propose thoughtful solutions that would allow Treasury to address the national security concerns identified in the President’s Executive Order without unnecessarily curtailing their investment activities.”

Swanson at CLK emphasizes that investor input is vital. “Even firms who are not currently subject to these restrictions should consider commenting,” she says, “as this program could grow to include more countries and more sectors.”

Steptoe & Johnson partner Dave Stetson agrees. “VC and PE firms would be well served by reviewing the proposed definitions of the key terms in the rules,” he says, “and by offering clear and well-reasoned feedback on how those proposals can be made more workable without undermining the government’s policy goals.”

“Ignore this opportunity at your own peril,” warns Ricardel at The Chertoff



Taft partner Sohan Dasgupta says VC and PE firms “might conduct deeper-dive internal investigations and audits to help themselves remain compliant with the rule,” should it be adopted. “Sometimes,” he says, “exercising an abundance of caution can be appropriate, especially where gratuitous risk is not advisable.”

Group. “The Comment Period is a vitally important opportunity to have input into and potentially shape the future rule.”

In the meantime, Swanson notes that VC and PE firms with any exposure to China – or to the semiconductor, quantum information technology, and artificial intelligence sectors – should “strongly consider a thorough review of their investments to determine whether those investments are covered by the ANPRM.”

Ricardel agrees. “My advice is to audit and assess current and future investment plans now,” she says. “Use this as a basis for informing input during the Comment Period.”

MORE INFORMATION

What did we miss? David Crosby of Nixon Peabody told us that, “In my view, your survey misses a whole industry that I think will be surprised: The corporate M&A and JV teams.” According to Crosby, “these regulations have the potential to have a greater impact because these corporate teams are looking to fill gaps or expand market opportunities and their options tend to be more limited.”

Agree? Should we do a corporate-specific survey? Let us know at editor@foreigninvestmentwatch.com.

Details on the [Executive Order](#) and [Advanced Notice of Proposed Rulemaking](#) are available.

RELATED ARTICLES

Talking export controls, sanctions with Dell
global compliance director

Breaking down TikTok's national security
agreement with CFIUS

Experts say outbound rule could impact
investments in the U.S.

[← Previous Article](#)

FOUNDING ADVISORS

 | **EISNERAMPER**


Hogan
Lovells


Morgan Lewis

WINSTON
& STRAWN

SIDLEY

GIBSON DUNN

FOREIGN INVESTMENT WATCH

[Home](#)
[About](#)
[Subscribe](#)
[Log In](#)

Sections

[Coverage](#)
[Filings and Reviews](#)
[Foreign Investments](#)
[Resources](#)

Editorial Contact

editor@foreigninvestmentwatch.com

Subscriptions, Other Contact

publisher@foreigninvestmentwatch.com

SUBSCRIBE

TRY IT FREE!

Foreign Investment Watch does not provide legal counsel or advice. Foreign Investment Watch is an unbiased, independent media company that is relentlessly focused on tracking the regulation of foreign investment for national security interests globally.

[Privacy Policy](#) | [Terms of Use](#)

© 2023 [Reg Media Group](#). All Rights Reserved.