



# Venture Capital and Supply Chain Vulnerabilities

## **When the Invisible Hand turns into a Sleight of Hand:**

### **Understanding How Venture Capital is used to Create Vulnerabilities in the Supply Chain**

One of the most potentially damaging vulnerabilities to a company comes in the form of a foreign adversary masquerading as a private investor. Whether seed money for early stage, high-risk start-ups, or an engine of pivotal middle market transformation, venture capital (VC) investors may provide the extra financial boost that a company needs to succeed. VC investors often gain a substantial foothold in a company through investment opportunities including capital expenditures (e.g. land and/or equipment purchases), or other operational or financial improvements to achieve growth. These investments may appear limited or are otherwise masked in a way that would not raise any alarms.

However, these seemingly nonthreatening transactions give foreign adversaries the opportunity to quietly insert board members, secure voting rights and/or access sensitive corporate data. They can then lie in wait for the right time to perform a sleight of hand that advances the interests of the foreign adversary, at the expense of the company and also, possibly, to U.S. economic or national security. By masking the true “investor,” these VC investments are able to either completely circumvent, or gain approval from, the Committee on Foreign Investment in the United States (CFIUS).<sup>1</sup>

To safeguard against inherent or introduced risks arising from this discreet investment vector, U.S. companies must be vigilant not only at the transaction phase, but also on a continuous basis through the lifetime of the investment. Extensive due diligence on any potential investor is necessary to manage and steer the resultant business risk, even if the investment or transaction is seemingly insignificant.

### **Venture Capital Investments into U.S. companies:**

VC is a form of private equity used to fund start-up or expansion of higher risk companies, with the expectation that higher risk will yield higher gains. VC generally flows from wealthy investors or investment funds.

While an investor’s interest may be held to a minority ownership, even VC investors with a minority ownership right may be afforded enough leverage to influence corporate decisions that ultimately control the company. For example, the investment agreement could grant a VC investor a controlling number of seats on the board or a VC investor could be designated as a preferred stockholder with options to veto certain decisions that could adversely affect its investment.<sup>2</sup> Through such mechanisms, a foreign entity may, with ample time and opportunity, exercise sufficient control or influence to direct or decide issues affecting corporate management or business operations that could either directly or indirectly compromise the resiliency or security of the targeted company’s supply chain. By exercising options to gain control of the

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<sup>1</sup> CFIUS was established to prevent nefarious investors seeking to harm U.S. interests through the foreign direct investment.

<sup>2</sup> “The Holloway Guide to Raising Venture Capital,” Andy Sparks, September 13, 2022.



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U.S. company, a VC investor is positioned as a foreign-government proxy to inflict harm to the U.S. company, U.S. economic security and/or U.S. national security.

This threat becomes even greater when the investors behind the venture capital fund company are not transparent. In this case, a company that enters into an agreement without knowing the origin of the funding may inadvertently be granting control of its company to a foreign adversary. This can be done through a series of shell companies incorporated in third countries that may not be subject to the same scrutiny as the actual country from which the investment funds originate. This was seen, for example, in April 2020 when foreign adversaries used shell companies to invest in struggling small defense firms during the Covid-19 pandemic.<sup>3</sup> The use of shell companies also enables foreign entities to skirt sanctions and other trade restrictions. One executive at a cloud services start-up in Shenzhen reported that the company had seen demands for chips “surge from ‘strange’ companies that masked their real identity behind shell companies.”<sup>4</sup>

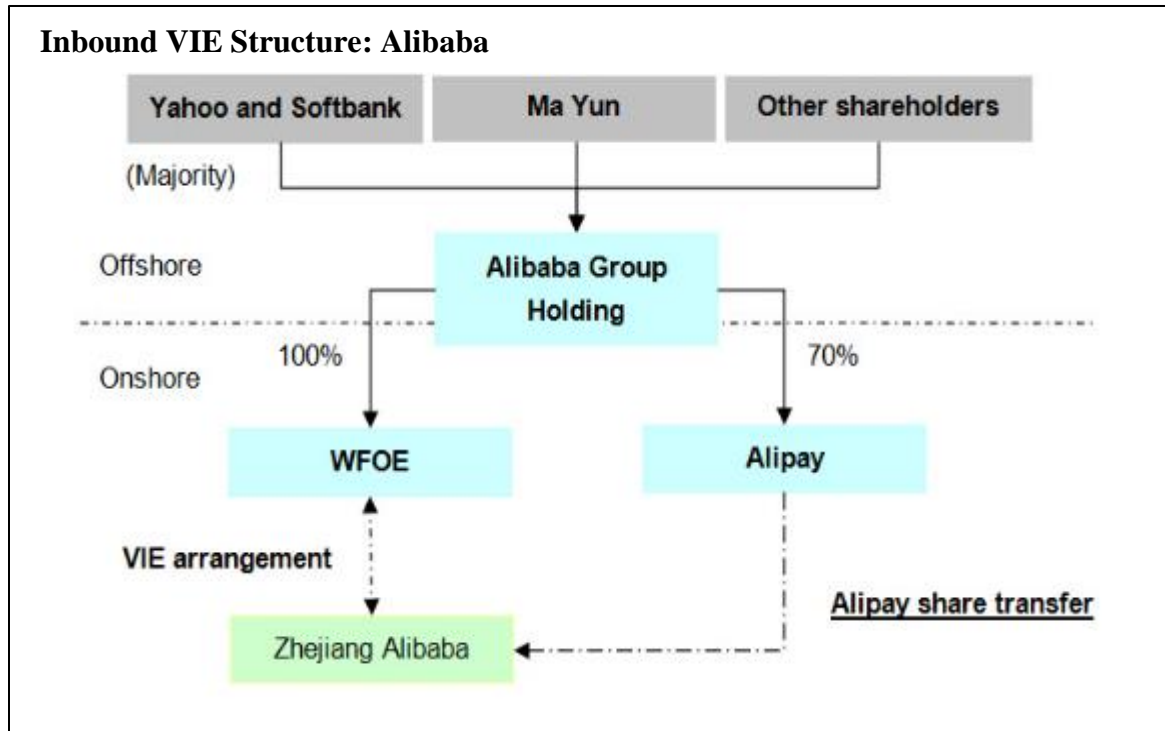
An example of this structure in reverse is the use of variable interest entities (VIE) by Chinese companies. This is a structure that Chinese companies began using in 2000. The VIE was originally used to allow foreign investment in Chinese companies that would have otherwise been prohibited by Chinese investment laws. The VIE structure uses an offshore company as the intermediary to facilitate the investment. The principle of this structure has since been reversed to provide a way for Chinese companies to invest in foreign stock exchanges and other investments from which they may have otherwise been prohibited. (See, e.g. Figure 1).<sup>5</sup>

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<sup>3</sup> “Foreign Shell Companies Trying to Infiltrate US Defense Industry, Top Weapons Buyer Says,” Military.com, May 1, 2020, available at, <https://www.military.com/daily-news/2020/05/01/foreign-shell-companies-trying-infiltrate-us-defense-industry-top-weapons-buyer-says.html>; For additional information on foreign adversary use of shell companies to gain access to sensitive information, see also “Remarks by Assistant Secretary for Export Enforcement Matthew S. Axelrod at the National Association of College and University Attorneys 2022 Annual Conference,” U.S. Department of Commerce Bureau of Industry and Security, June 02, 2022, available at, <https://www.bis.doc.gov/index.php/documents/about-bis/newsroom/3045-2022-06-28-remarks-as-axelrod-nacua-2022-conference/file>.

<sup>4</sup> “Chinese AI groups use cloud services to evade US chip export controls,” The Financial Times, March 8, 2023, available at, <https://www.ft.com/content/9706c917-6440-4fa9-b588-b18fbc1503b9>.

<sup>5</sup> “Variable Interest Entity (VIE) Structure for Foreign Investment in the PRC May Face Challenge,” China Law Insight, October 20, 2011, available at, <https://www.chinalawinsight.com/2011/10/articles/foreign-investment/variable-interest-entity-vie-structure-for-foreign-investment-in-the-prc-may-face-challenge/>.



Source: Variable Interest Entity (VIE) Structure for Foreign Investment in the PRC May Face Challenge. China Law Insight

Figure 1: This chart illustrates the VIE structure used by Alibaba that enabled foreign investment to come through Alibaba Group Holding before ultimately going into Zhejiang Alibaba (2011).

## Review of Foreign VC Investments:

Historically, VC was not subject to CFIUS review, and so this was a venue through which foreign companies could gain entrée into a U.S. company with limited scrutiny. For example, a 2019 report by the U.S.-China Economic and Security Review Commission stated that Chinese VC investments typically targeted strategic industries such as AI, autonomous vehicles, virtual reality, robotics, and blockchain technology. It cited a 2018 Rhodium Group study that found that between 2000 and May 2018, Chinese investors targeted these strategic technologies in 78 percent of all U.S. VC funding rounds involving a Chinese investor.<sup>6</sup>

<sup>6</sup> “How Chinese Companies Facilitate Technology Transfer from the United States,” U.S.-China Economic and Security Review Commission, May 6, 2019, available at, <https://www.uscc.gov/sites/default/files/Research/How%20Chinese%20Companies%20Facilitate%20Tech%20Transfer%20from%20the%20US.pdf>.



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A separate Rhodium study calculated that, on average, 21 percent of Chinese venture investment in the United States from 2000 through 2017 came from state-owned funds, which were controlled, at least in part, by the Chinese government. In 2018, that figure surged to 41 percent.<sup>7</sup>

In an effort to address these issues, Congress passed, and the White House signed, the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) as part of the National Defense Authorization Act, which expanded the scope of CFIUS to include certain VC transactions.<sup>8</sup> These new covered transactions include:

1. Purchase, lease, or concession by or to a foreign person of real estate located in proximity to sensitive government facilities;
2. “Other investments” in certain U.S. businesses that afford a foreign person access to material nonpublic technical information in the possession of the U.S. business, membership on the board of directors, or other decision-making rights, other than through voting of shares;
3. Any change in a foreign investor’s rights resulting in foreign control of a U.S. business or an “other investment” in certain U.S. businesses;
4. Any other transaction, transfer, agreement, or arrangement designed to circumvent CFIUS jurisdiction<sup>9</sup>

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<sup>7</sup> “Chinese Tech Investors Flee Silicon Valley as Trump Tightens Scrutiny,” Reuters, January 7, 2019, available at, <https://www.reuters.com/article/us-venture-china-regulation-insight-idUSKCN1P10CB>.

<sup>8</sup> “H. R. 5515—538 TITLE XVII—REVIEW OF FOREIGN INVESTMENT AND EXPORT CONTROLS Subtitle A—Committee on Foreign Investment in the United States Sec. 1701,” U.S. Department of Treasury, August 2018, available at, [https://home.treasury.gov/sites/default/files/2018-08/The-Foreign-Investment-Risk-Review-Modernization-Act-of-2018-FIRRMA\\_0.pdf](https://home.treasury.gov/sites/default/files/2018-08/The-Foreign-Investment-Risk-Review-Modernization-Act-of-2018-FIRRMA_0.pdf).

<sup>9</sup> “Summary of FIRRMA,” U.S. Department of Treasury, January 13, 2020, available at, <https://home.treasury.gov/system/files/206/Summary-of-FIRRMA.pdf#:~:text=The%20Foreign%20Investment%20Risk%20Review%20Modernization%20Act%20of,enable%20timely%20and%20effective%20reviews%20of%20covered%20transactions.>



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These CFIUS changes have increased the scrutiny for incoming investment cases, with overall CFIUS cases up about 30%. (Figure 2).<sup>10</sup>

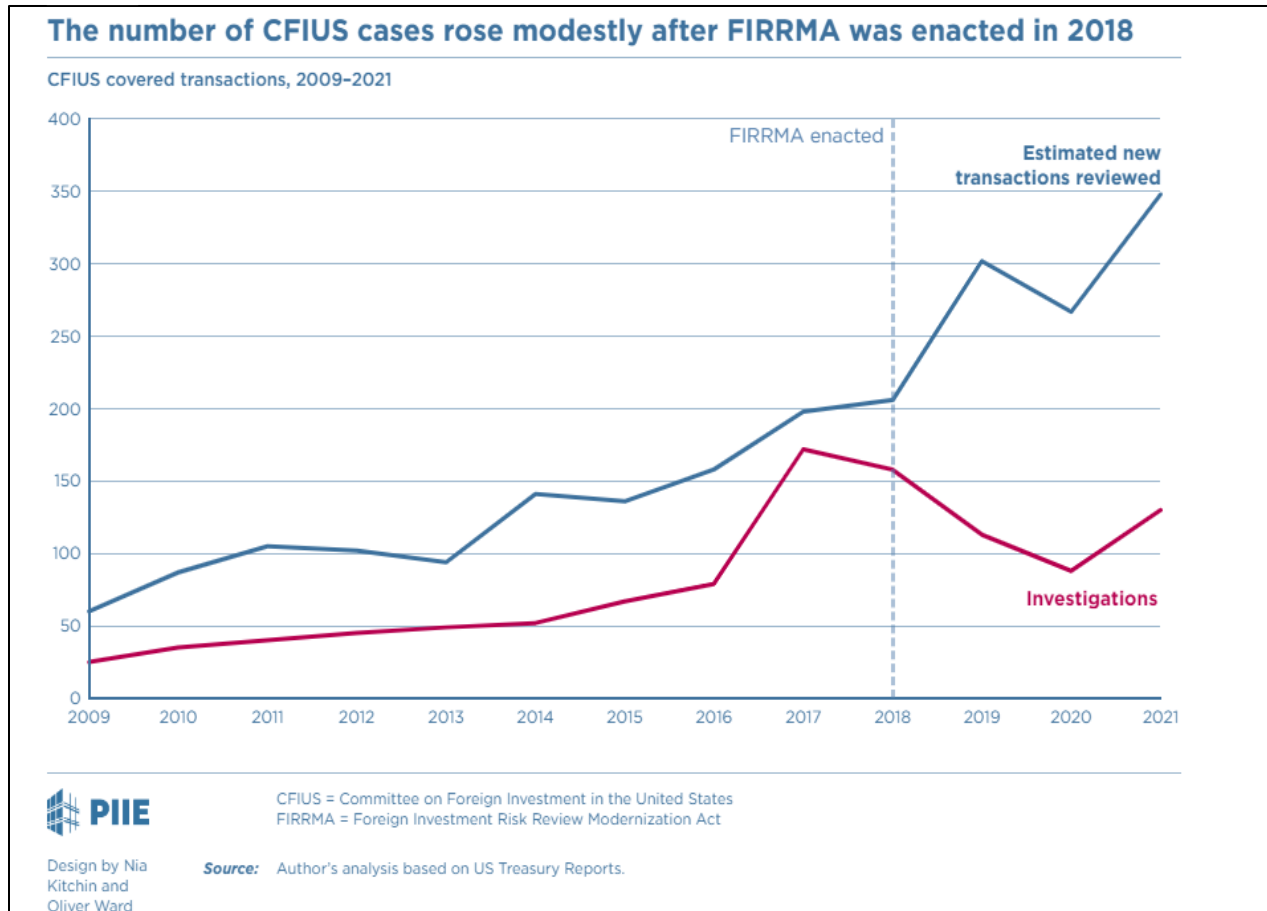


Figure 2: Since the 2018 enactment of FIRRMA, the number of covered transactions reviewed has increased from an estimated 200 cases to almost 350 cases.

<sup>10</sup> “US Security Scrutiny of Foreign Investment Rises, but so Does Foreign Investment,” Peterson Institute for International Economics, September 20, 2022, available at, [https://www.piie.com/blogs/realtime-economic-issues-watch/us-security-scrutiny-foreign-investment-rises-so-does-foreign%23\\_ftnref5](https://www.piie.com/blogs/realtime-economic-issues-watch/us-security-scrutiny-foreign-investment-rises-so-does-foreign%23_ftnref5).



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The increased scrutiny can especially be seen with investment from China. Investments from China receive almost 15% of the total CFIUS reviews, even though its investment only accounts for 4% of the foreign mergers and acquisitions (M&A) received in the U.S. (Figure 3).<sup>11</sup>

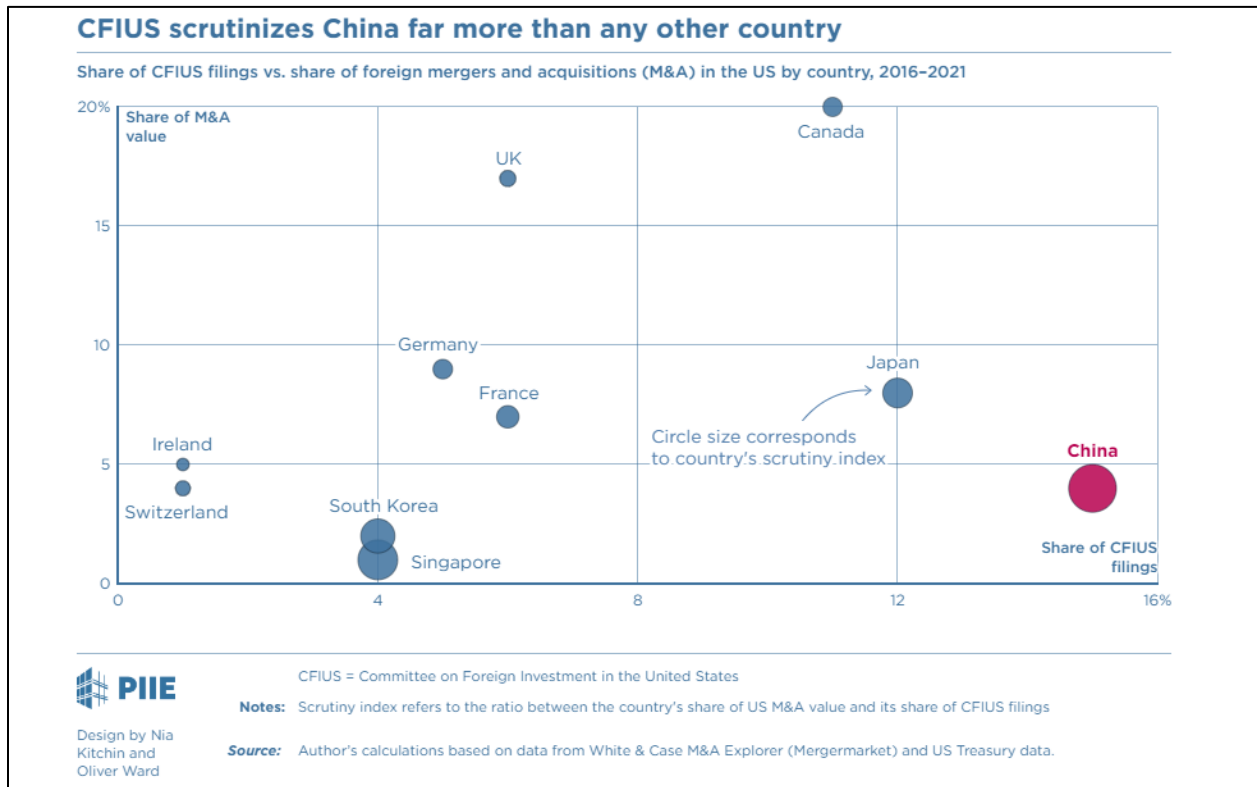


Figure 3: The "Scrutiny Index" is determined by the percentage of foreign M&A the country accounts for in the U.S. against the percentage of investments that had CFIUS reviews. The higher the number, the more likely that a country's investments will need to file with CFIUS.

<sup>11</sup> *Id.*



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## Impact of Increased Scrutiny:

It would seem logical, then, that with these new restrictions, the use of VC would be falling. However, that is not the case across the board. While certain industries have seen this, overall, VC has continued to have a significant role in the U.S. The use of VC in the U.S. has increased exponentially in the last several years, with 2020 VC investments coming in at almost \$150 billion. (Figure 4).<sup>12</sup>

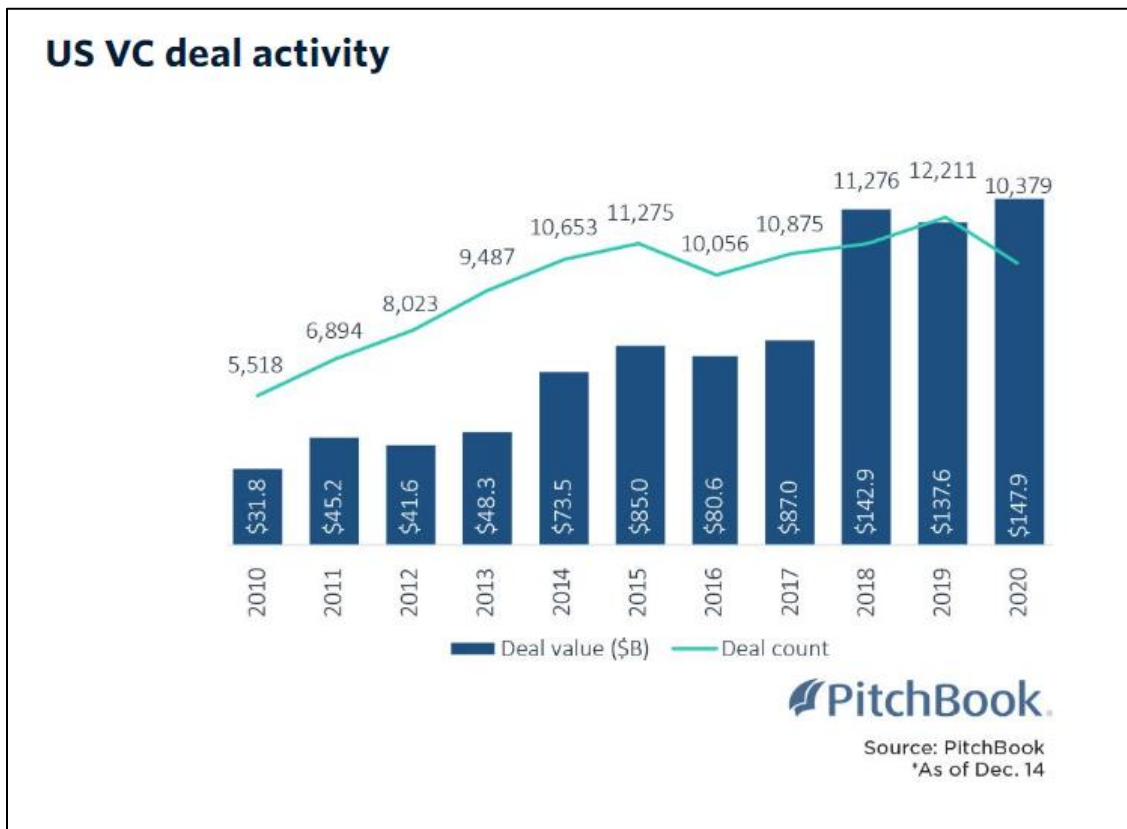


Figure 4: The dollar value of VC coming into the U.S. increased by almost 61% between 2017 and 2018.

<sup>12</sup> “The Year in Charts: VC Defies 2020 Expectations Despite the Pandemic,” Pitchbook, December 20, 2020, available at, <https://pitchbook.com/news/articles/2020-vc-in-charts>.





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VC coming into the U.S. from Chinese investors in 2020 has largely mirrored that trend, with total VC of \$3.2 billion, in 249 unique funding rounds. (Figure 5).<sup>13</sup>

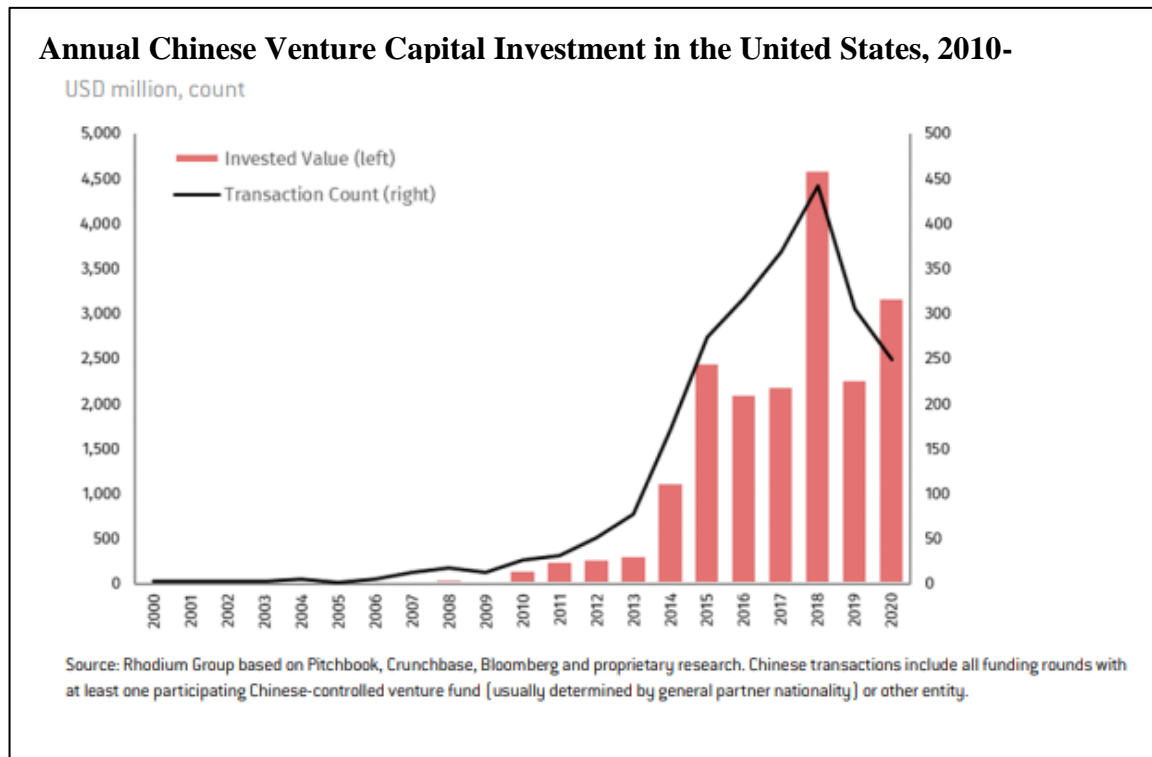


Figure 5: Chinese VC into the U.S. has increased exponentially since 2011. The number of transactions are decreasing, but the value per transaction is on the rise.

Notably, of those 249 unique funding rounds in 2020, the Health, Pharmaceuticals and Biotechnology sector accounted for 132 of them. (Figure 6). This sector is not generally found to fall under the CFIUS guidelines. For example, one of those investments was for Lyell Immunopharma. Lyell is California-based clinical-stage T-cell reprogramming company advancing a diverse pipeline of cell therapies for patients with solid tumors.<sup>14</sup> The almost half billion dollar investment came from Sequoia Capital China, one of China’s largest investment firms.<sup>15</sup>

<sup>13</sup> “Two-Way Street: 2021 Update US-China Investment Trends,” The US-China Investment Project, May 2021, available at, [https://rhg.com/wp-content/uploads/2021/05/RHG\\_TWS-2021\\_Full-Report\\_Final.pdf](https://rhg.com/wp-content/uploads/2021/05/RHG_TWS-2021_Full-Report_Final.pdf).

<sup>14</sup> “Lyell Immunopharma Reports Business Highlights and Financial Results for the Fourth Quarter and Full Year 2022,” Lyell Press Release, Feb. 28, 2023, available at, <https://ir.lyell.com/news-releases/news-release-details/lyell-immunopharma-reports-business-highlights-and-financial>.

<sup>15</sup> “Two-Way Street: 2021 Update US-China Investment Trends,” The US-China Investment Project, May 2021, available at, [https://rhg.com/wp-content/uploads/2021/05/RHG\\_TWS-2021\\_Full-Report\\_Final.pdf](https://rhg.com/wp-content/uploads/2021/05/RHG_TWS-2021_Full-Report_Final.pdf).





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Another example in this sector was the 2020 acquisition of 40% of GNC Holdings Inc. to Harbin Pharmaceutical Group Holding Co. for \$770 million.<sup>16</sup> Harbin Pharmaceutical Group is a partially Chinese state-owned company, with Chinese state owned CITIC Capital Holdings as one of its main investors.<sup>17</sup>

These are but two examples of hundreds of Chinese investments into companies with a national security nexus. A detailed list of investments is at: [China Global Investment Tracker | American Enterprise Institute - AEI](#).

## **The Bottom Line: Protect Your Supply Chain by Knowing Your Investor:**

VC has traditionally fallen under the radar from significant governmental oversight. This has made VC investment a permissive target for foreign investors, including state actors, seeking to gain a foothold into the supply chain of a new technology or an area of national security or strategic interest. Before entering into a VC investment agreement, it is critical that companies conduct robust due diligence to ensure that they do not fall victim to the sleight of hand of a foreign adversary hiding behind the façade of a true private investor, waiting to inflict damage to the U.S. company, economic security or national security.

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<sup>16</sup>“GNC sold to Chinese pharmaceutical group,” Tribune Review, September 18, 2020, available at, <https://triblive.com/business/gnc-sold-to-chinese-pharmaceutical-group/#:~:text=%2C%20the%20Pittsburgh-based%20international%20health%20and,Thursday%20in%20bankruptcy%20court%20in%20Delaware.&text=%2C%20the%20Pittsburgh-based%20international,bankruptcy%20court%20in%20Delaware.&text=Pittsburgh-based%20international%20health%20and,Thursday%20in%20bankruptcy%20court>.

<sup>17</sup> “Harbin Pharmaceutical Group,” Crunchbase, last visited March 7, 2023, available at, <https://www.crunchbase.com/organization/harbin-pharmaceutical-group-co-ltd>.