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CFIUS: What Private Equity Funds Need To Know About Mandatory Declarations and the Expansion of Transactions Subject To Review

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The United States recently enacted the Foreign Investment Risk Review Modernization Act ("FIRRMA"), which both expands jurisdiction and codifies recent practices of the Committee on Foreign Investment in the United States ("CFIUS").[1] As a result, CFIUS may now review the national security implications of acquisitions of control by foreign investors of U.S. businesses, certain minority investments and real estate acquisitions. If CFIUS finds a national security concern, it can seek mitigation, block a pending transaction or force divestiture of completed transactions. Exercising its new authority, CFIUS recently released interim rules, effective Nov. 10, 2018, relating to examinations of non-controlling foreign investments in critical technology, and requiring new mandatory pre-closing filings called "Declarations."[2]

FIRRMA makes a number of jurisdictional and procedural changes to CFIUS's ability to review foreign investment in the United States. The full impact of FIRRMA will not be evident until all of its implementing regulations take effect. U.S. private equity funds that have significant investors from countries of recent CFIUS concern or that invest in critical technology industries should pay careful attention to the changes.

The FIRRMA Pilot Program Signals Aggressive Expansion of CFIUS Review and Enforcement, but Leaves Unanswered Questions

CFIUS has initiated a FIRRMA-authorized pilot program, which goes into effect on Nov. 10, 2018, that requires mandatory Declarations for certain transactions involving investments by foreign persons in certain U.S. businesses that produce, design, test, manufacture, fabricate or develop certain enumerated critical technologies. As a pilot program under FIRRMA, CFIUS was able to quickly implement these changes prior to the adoption of final rules and without observing the usual notice and comment period for new regulations. At least until supplanted by final rules or until the pilot program expires on Feb. 13, 2020, all foreign investments that fall within the scope of the pilot program are subject to the mandatory Declaration filing requirements. Parties who fail to file a required Declaration face potentially severe penalties of an amount up to the full value of the transaction. This is the first time that CFIUS has had the authority to impose financial penalties.

Because of the risk of significant fines for noncompliance, the mandatory filing requirement makes, for the first time, the precise extent and scope of CFIUS definitions and requirements significant. Under the new rules, transactions that do not raise national security issues could nonetheless incur significant penalties if the parties fail to file based on their incorrect interpretation of a particular definition or

[1] Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), Subtitle A of Title XVII of Public Law 115–232 (Aug. 13, 2018).

[2] *See* 83 FR 51322 (Oct. 11, 2018).

regulation, or if CFIUS takes a contrary view on how they should be interpreted. For example, under CFIUS, a "foreign entity," such as a Cayman Island fund, may not be a "foreign person" if it is ultimately controlled by U.S. individuals and no foreign individual, entity or government has any significant ability to control it. However, aside from a safe harbor described below, CFIUS has yet to provide clear guidance for funds that fall outside of its protection. Because of significant remaining ambiguity, many law firms have started to exclude CFIUS from their legal opinion letters pending greater clarity from the Treasury Department.

CFIUS May Now Review Acquisitions of Certain Non-Controlling Interests in US Businesses
Prior to FIRRMA, only transactions that resulted in "control" of a U.S. business were covered by CFIUS, with passive investments under 10 percent excluded from CFIUS jurisdiction. Now, any investment that does not result in "control" of a U.S. business can be a covered transaction if it provides a foreign investor with (1) access to nonpublic technical information; (2) board membership, observer rights or rights to nominate a director; or (3) any "involvement" in the U.S. business's substantive decision-making regarding critical infrastructure, critical technologies or sensitive personal data of U.S. citizens. Previously, such non-controlling influence over an issuer, such as a board seat, was not by itself sufficient to trigger CFIUS jurisdiction. (However, CFIUS had asserted jurisdiction over such transactions in several instances despite lacking clear legislative authority to do so.)

CFIUS Gains Authority To Review US Real Estate Acquisitions and Long-Term Leases
FIRRMA extends CFIUS' authority to the review of real estate acquisitions. Previously, CFIUS was limited to review of acquisitions of an existing "U.S. business," which did not include empty land or buildings. Nonetheless, CFIUS in practice had begun challenging the foreign acquisition of real estate near sensitive government facilities starting in 2012 with the *Ralls* windfarm case, and later reviews of foreign acquisitions of the New York Waldorf Astoria Hotel and the San Diego Hotel del Coronado. FIRRMA codifies this ability of CFIUS to review foreign acquisitions of U.S. real estate. This review authority does not extend to real estate loans or financing unless the foreign person would acquire governance or financial rights comparable to an equity investment.

CFIUS Gains Greater Resources To Review a Broader Range of Transactions
Previously, CFIUS was a largely voluntary process. Parties to foreign acquisitions of U.S. businesses generally self-determined whether notification was advisable. Voluntary filings were made when some question existed about whether CFIUS may object to a transaction, or if the buyer or lenders wanted assurance that the transaction would not be subject to CFIUS sanction. FIRRMA, for the first time, gives CFIUS the power to require the mandatory filing of notifications, specifically for acquisitions of U.S. businesses where a foreign government has a "substantial interest" in the buyer, and in other circumstances as CFIUS may choose to add. (Such mandatory "notifications" await further rulemaking and are not yet required, as opposed to the mandatory Declarations that go into effect Nov.10, 2018.)

In addition to requiring mandatory notifications and significantly expanding the types of transactions subject to CFIUS review, FIRRMA also provides an additional $20 million of annual funding for CFIUS enforcement. Even more CFIUS funding is anticipated to result when its new authority to impose filing fees of up to $300,000 per transaction is implemented. These additional resources should enable CFIUS to cast a wider net, and will likely lead to it taking a closer look at more transactions, including those that are not notified.

A New Safe Harbor Excludes Certain Private Equity Funds with Foreign Investors from CFIUS Review of Acquisitions of Non-Controlling Interests in US Businesses

Given the imposition of mandatory reporting, FIRRMA provides some relief to private equity funds that have foreign investors, including foreign government investors, so that they are not required to make mandatory CFIUS filings in certain circumstances. In particular, FIRRMA provides a safe harbor exemption for acquisitions made by a U.S.-controlled investment fund with foreign limited partners. Subject to further rulemaking, a foreign limited partner that invests through such a fund and participates in a fund advisory board or committee will not result in the fund's acquisition constituting a covered "other investment" if (1) the fund is managed exclusively by a U.S. general partner; (2) the fund's advisory board does not have the ability to approve, disapprove or otherwise control the investment decisions of the fund or its GP; (3) the foreign investors do not have access to material non-public technical information related to the fund's investments; and (4) the foreign investors do not otherwise have such control over the fund's investments or its GP, including the right to unilaterally dismiss, select or determine the compensation of the GP.

It is important to note that this safe harbor only applies to non-controlling investments by a U.S. fund. It does not apply to a fund's acquisition of control over a U.S. business, nor to real estate acquisitions. However, the carve-out is consistent with (a) prior advice that a GP that operates an investment fund is considered to be solely controlled by its GP if the LP members have no authority to determine, direct or decide important matters affecting the partnership and any fund it operates (31 CFR § 800.204, Example 8); and (b) methods CFIUS has used to allow parties to proceed with a transaction after mitigating foreign ownership, control and influence by placing sole management control in the hands of U.S. citizens.

Further, though future regulations may provide more clarity, it is likely that CFIUS will view a "fund of one," certain co-investment vehicles and managed accounts of a foreign investor as cases in which the foreign investor "otherwise has the ability to control the fund," making the safe harbor inapplicable.

Private Equity Funds Should Assess How FIRRMA May Affect Their Investment Strategies

Sponsors of private equity funds that make non-controlling investments in issuers and companies that operate U.S. businesses that deal in critical infrastructure, critical technology, or that maintain or collect sensitive personal data of U.S. citizens, may wish to review their fund documents, including LP agreements, to see if their organizational structure meet the requirements for the safe harbor described above or, if they do not, how they might be able to modify their governance in order to qualify.

Foreign investors and funds with foreign investors should evaluate how FIRRMA and the new pilot program may increase the risk of CFIUS action with respect to transactions they are contemplating. It is now essential for funds to consult with CFIUS experts prior to formulating their investment strategies with respect to companies involved in critical technology, critical infrastructure and collection of sensitive personal data of U.S. citizens.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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