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CFIUS Reform: Key Questions for Private Funds to Consider

December 5, 2018

Private Funds and CFIUS

Earlier this year Congress passed and President Trump signed the Foreign Investment Risk Review Modernization Act ("FIRRMA"), transformational legislation reforming the operations of the Committee on Foreign Investment in the United States ("CFIUS"). The U.S. Department of the Treasury, as chair of CFIUS, has begun the process of implementing FIRRMA, effective November 10, 2018, with the issuance of a "Pilot Program"—essentially a form of interim regulation—that mandates filings with CFIUS for certain investments related to so-called critical technologies.

Despite recognizing and addressing the unique characteristics and governance of private investment funds, the definitions and application of the Pilot Program are quite broad, and in turn FIRRMA and the Pilot Program bear substantially on how private funds should consider their management, investor relationships, and investments. These considerations merit careful analysis under the CFIUS regulations, and investment funds are well advised to consult with CFIUS counsel early to understand the CFIUS impact on their fund structure and potential transactions.

The below questions and related discussion address key points for investment funds to consider in this new landscape.

1. Is the fund a "foreign person" subject to CFIUS jurisdiction?

The Pilot Program embraces the historically expansive definition of "foreign persons" subject to CFIUS jurisdiction. Under CFIUS's existing regulations, which the Pilot Program leverages for its new applications, "foreign person" is defined not only as any "foreign national, foreign government, or foreign entity" but also as "[a]ny entity over which control is exercised or exercisable by a foreign national, foreign government, or foreign entity." Thus, whether or not an investment fund will be considered a foreign person depends on whether that fund could be viewed as under the "control" of any foreign person. "Control" for CFIUS purposes is an expansive and flexible concept that can capture even small minority investments. Specifically, control is defined to mean "the power, direct or indirect, whether or not exercised . . . to determine, direct, or decide important matters affecting an entity."

The definition of "foreign entity" is also especially relevant to investment funds. "Foreign entity" is defined by regulation as "any [entity] organized under the laws of a foreign state if either its principal place of business is outside the United States or its equity securities are primarily traded on one or more foreign exchanges." However, the regulations provide an exception to the definition of foreign entity: "notwithstanding [the prior definition], any [entity] that

demonstrates that a majority of the equity interest in such entity is ultimately owned by U.S. nationals is not a foreign entity." Thus, if a fund that is not otherwise under the control of a foreign person can demonstrate that a majority of the equity interest in the fund is ultimately owned by U.S. nationals, or its principal place of business is within the United States, the fund is not a "foreign entity" and therefore not a "foreign person."

For investment funds, it will be critical to analyze any foreign ownership interests or control rights over the general partner or manager. If the general partner or manager is under control by a foreign person, then every fund managed and controlled by the general partner or manager will be considered a foreign person subject to CFIUS jurisdiction. Whether the general partner or manager is under the control of a foreign person will be analyzed under the expansive definition of "control" above.

Funds must also evaluate whether any foreign limited partner may have rights or interests that would be viewed by CFIUS as conferring control of the fund. FIRRMA and the Pilot Program include a "special clarification" for investment funds that effectively provides a road map for the rights that foreign limited partners may have—including through participation on a limited partner advisory committee—without being viewed as controlling. To fall within the scope of this special clarification:

- the fund must be managed exclusively by a general partner, managing member or equivalent who is not a foreign person (which, as noted, means any general partner, managing member or equivalent that is neither itself a foreign person nor controlled by a foreign person);
- no foreign limited partner or advisory committee on which a foreign limited partner serves can have the ability to (1) approve, disapprove, or otherwise control investment decisions of the fund, or (2) approve, disapprove, or otherwise control decisions made by the general partner related to entities in which the investment fund is invested, though advisory committees may have the authority to waive potential conflicts of interest or waive allocation limitations;
- no foreign limited partner may have the right unilaterally to control the dismissal, appointment, or compensation of the general partner; and
- no foreign limited partner may otherwise have the ability to exercise control over the fund or the general partner.

Apart from the specific rights described above, funds will need to determine if any foreign limited partner has any right or interest that could be viewed by CFIUS as conferring control of the fund to that foreign limited partner. Under CFIUS's historical application of its regulations, a fund is presumed to be a foreign person if any foreign limited partner has 50 percent or more of the interest in the fund, or if multiple foreign limited partners are acting in concert and collectively hold 50 percent or more. If funds do have foreign limited partners with rights that could render the fund a foreign person, then the fund and the limited partner may wish to renegotiate those rights so as to limit the potential CFIUS impact on the fund and the limited partner.

2. How does being a "foreign person" impact transactions for private funds?

FIRRMA and the Pilot Program have two principal consequences for funds that are foreign persons. First, FIRRMA expands the scope of transactions subject to CFIUS review, meaning that a broader range of transactions—including very small equity investments—will now be

subject to CFIUS jurisdiction. Second, certain transactions will now be subject to mandatory filings.

Under FIRRMA, CFIUS retains its current jurisdiction to review any transaction that results in foreign control of a U.S. business, and also gains jurisdiction to review (1) certain investments in real estate near sensitive U.S. government facilities or which involve air or maritime ports, and (2) certain non-passive investments (regardless of whether or not investment confers control) in critical technology companies, critical infrastructure companies, and companies that collect, process, or store sensitive personal data of U.S. citizens. Investment funds, together with their counsel, will need to undertake an analysis as to whether or not it is prudent to submit a voluntary notice to CFIUS regarding a far broader range of transactions than before.

FIRRMA for the first time establishes certain types of mandatory filings—known as "declarations"—with CFIUS. Specifically, under FIRRMA, any acquisition of a "substantial interest" by a foreign person in which a foreign government has a "substantial interest" will be subject to a mandatory declaration with CFIUS for certain categories of U.S. businesses. This provision will not go into effect until the promulgation of implementing regulations, and "substantial interest" will need to be defined in those regulations. Depending on how CFIUS chooses to define "substantial interest," investment funds with significant foreign government-controlled limited partners may find that they are subject to mandatory filings for a range of investments in U.S. businesses.

FIRRMA also provides CFIUS broad authority to mandate declarations for certain other investments involving critical technologies. Relying on this authority, the Pilot Program requires a mandatory declaration for certain investments by a foreign person in a U.S. business that produces, designs, tests, manufactures, fabricates, or develops a critical technology that is either utilized in connection with the U.S. business's activity in one or more of the 27 specified pilot program industries, or designed by the U.S. business specifically for use in one or more pilot program industries. The investments subject to this requirement cover any equity or contingent equity accompanied by any of the following rights:

- access to any material nonpublic technical information in the possession of the U.S. business;
- membership, nomination, or observer rights on the board of directors or equivalent governing body of the U.S. business; or
- any involvement, other than through voting of shares, in substantive decision-making of the U.S. business regarding the use, development, acquisition, or release of critical technology.

Mandatory declarations are forms submitted online that include, among other items, information on the foreign person(s); a description of the transaction; a statement regarding whether the foreign party will have access to nonpublic technical information and a description of such access; a description of the U.S. business, including addresses or geocoordinates of all facilities of the U.S. business; a description of any critical technology that the U.S. business produces, designs, tests, manufactures, fabricates, or develops; a statement regarding whether the U.S. business has any U.S. government contracts, including classified contracts, or has received grants or funding from the Departments of Energy or Defense; and a complete organizational chart.

Upon receiving a declaration, CFIUS has 30 days to reach one of the following determinations:

- request the parties submit a full notice of the transaction;
- inform the parties that CFIUS is not able to complete action on the basis of the declaration and that the parties may submit a full notice to seek CFIUS approval;
- initiate a unilateral review of the transaction; or
- notify the parties that CFIUS has completed action (i.e. approved the transaction).

If CFIUS completes final action on the basis of a declaration, the legal "safe harbor" that historically has attached to CFIUS approvals applies with regard to the investment as described in the declaration. However, transactions approved on the basis of a declaration do not receive legal safe harbor for subsequent additional equity accruals or changes of rights in the same U.S. business.

3. How does CFIUS affect private funds that are not "foreign persons"?

Funds that are not deemed foreign persons, and therefore are not subject to CFIUS jurisdiction, must nonetheless take CFIUS into account when raising commitments from their investors and evaluating transactions in the United States.

- First, funds should consider working together with foreign limited partners to agree on terms and policies to ensure that those foreign limited partners are not viewed by CFIUS as undertaking an indirect investment into a portfolio company that could trigger CFIUS jurisdiction (and potentially a mandatory filing with respect to the initial portfolio company investment and any U.S. add on investments). Under FIRRMA and the Pilot Program, an investment by a limited partner in a fund may be viewed as an indirect investment into a portfolio company if the limited partner has the right to receive "material nonpublic technical information" of the portfolio company. If a portfolio company is a "critical technology" company subject to the Pilot Program, the limited partner's right to receive material nonpublic technical information could result in a mandatory declaration requirement being triggered.
- Second, recognizing that U.S. funds in many circumstances will want to bring in foreign limited partners as co-investors, it will be important for funds to consider and plan for the CFIUS implications to ensure that the necessary capital can be available at the closing without unnecessarily slowing the transaction.
- Third, funds that invest in the United States, especially those that invest in critical technology companies subject to the pilot program, will likely be asked by sellers to provide representations that they are not foreign persons. Likewise, when funds sell U.S. businesses, they may be asked to represent that the U.S. business is not subject to the Pilot Program. Funds should consult with experienced counsel to confirm that they can safely provide such representations.
- Finally, when a fund seeks to exit an investment or re-sell secondary investments in the United States, the fund should consider whether the applicable sale transaction would fall within CFIUS's jurisdiction and if so, consider from the outset the universe of likely buyers and the potential CFIUS impact on a sale transaction.

For additional information on the passage of FIRRMA and the Pilot Program, please see our prior alerts: "CFIUS Update: FIRRMA Finalized, Nears Passage", "CFIUS Update: FIRRMA Enacted into Law", "CFIUS Update: Treasury Department Issues Interim Rules, Expands Jurisdiction to Certain Non-Controlling Investments, and Establishes Mandatory Filing Requirements", and "Commerce Requests Comment on Criteria for Identifying Emerging Technologies that Are Essential to U.S. National Security".

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Private Equity, Private Funds, and CFIUS practices:

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