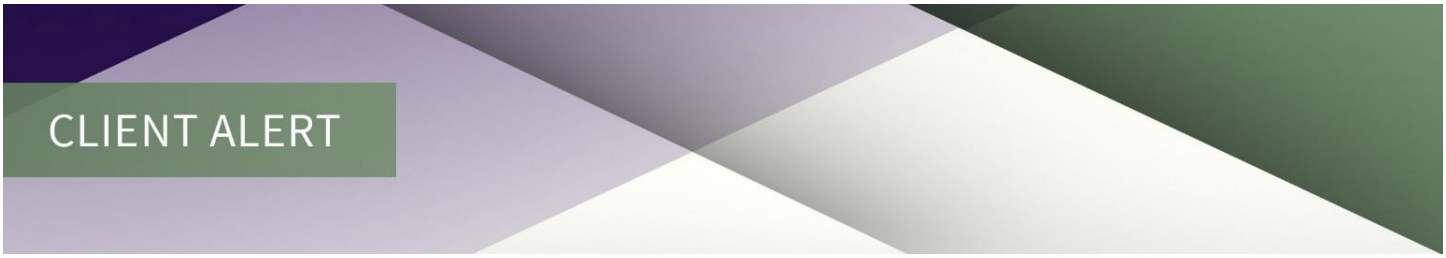

CFIUS Reform to Create Unique Issues for Private Equity

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On August 13, 2018, President Trump signed the *John S. McCain National Defense Authorization Act for Fiscal Year 2019*, a spending bill that includes the "Foreign Investment Risk Review Modernization Act of 2018" or "FIRRMA." The law will expand the Committee on Foreign Investment in the United States' ("CFIUS") jurisdiction to new types of transactions, make the filing of a pre-closing notice mandatory in some situations, and change the timeline and procedures for seeking approval for a transaction from CFIUS. While a full description of the legislation is available here, this alert focuses on issues of specific concern to private equity funds. FIRRMA provides a fairly explicit "road map" for private equity to determine whether the interests of foreign investors will implicate CFIUS jurisdiction for U.S. investments. Many of these changes will not go into effect until CFIUS issues regulations within the next 18 months, but private equity funds should begin to consider how rights afforded to their foreign investors may trigger the CFIUS process for investments, including minority investments, in U.S. business operations.

I. CFIUS Jurisdiction Extended to Non-Controlling Foreign Investments

Most notably for private equity, FIRRMA amends the definition of "covered transaction" to extend CFIUS jurisdiction. Currently, CFIUS has jurisdiction to intervene in any "mergers, acquisitions, or takeovers that could result in foreign control." Prior to the enactment of FIRRMA, CFIUS extended the definition of control, based on a series of factors in its regulations, to cover minority foreign investments that have the power to determine, direct, or decide important matters affecting an entity. Under this standard, control may be effectuated through a majority or dominant minority voting interest, board representation, proxy voting, special share, or some other arrangement.

While CFIUS's current jurisdiction therefore extends to controlling minority investments by foreign persons, FIRRMA extends CFIUS jurisdiction to cover certain non-controlling investments by foreign persons, including certain non-controlling investments by funds with foreign investors. Specifically, CFIUS jurisdiction will extend to non-controlling foreign investments in unaffiliated U.S. businesses, provided that the U.S. business:

- "owns, operates, manufactures, supplies, or services 'critical infrastructure';"
- "produces, designs, tests, manufactures, fabricates, or develops one or more 'critical technologies'; or"
- "maintains or collects sensitive personal data of United States citizens that may be exploited in a manner that threatens national security";

To qualify as a covered transaction, the non-controlling foreign investment must also afford the foreign investor in the private equity fund:

- "access to any material non-public technical information in the possession of the United States business [where financial information about the performance of a U.S. business does *not* constitute 'material nonpublic technical information'];"
- "membership or observer rights on the board of directors or equivalent governing body of the United States business or the right to nominate an individual to a position on the board of directors or equivalent governing body; or"
- "involvement, other than through voting shares, in substantive decision making" regarding "sensitive personal data of United States citizens" that the business collects or maintains, "critical technologies," or "critical infrastructure."

II. Carve-Out for Investment Funds

FIRRMA excludes certain investment fund transactions involving sensitive U.S. companies from the new category of covered non-controlling investments. Specifically, when an investment in a U.S. business by an otherwise U.S. fund qualifies as a foreign investment by virtue of a foreign person's membership on an advisory board or a committee of the fund as a limited partner, the investment will not be subject to CFIUS jurisdiction over non-controlling investments if the fund meets certain criteria:

- "the fund is managed exclusively by a general partner, a managing member, or an equivalent" who is not a foreign person;
- "the advisory board or committee does not have the ability to approve, disapprove, or otherwise control—"

  - "investment decisions of the fund; or"
  - "decisions made by the general partner, managing member, or equivalent related entities in which the fund is invested;"

- "the foreign person does not otherwise have the ability to control the fund, including authority—"
  - to approve, disapprove, or otherwise control investment decisions of the fund;"
  - "to approve, disapprove, or otherwise control decisions made by the general partner, managing member, or equivalent related entities in which the fund is invested; or"
  - "to unilaterally dismiss, prevent the dismissal of, select, or determine the compensation of the general partner, managing member, or equivalent;"
- "the foreign person does not have access to material nonpublic technical information as a result of its participation on the advisory board or committee".

The above criteria for excluding certain investment fund transactions from qualifying as covered non-controlling investments are also subject to regulatory elaboration by CFIUS. The details of how this carve-out for investment funds is further defined through regulation will likely influence the structure and governance of investment funds that have foreign limited partners.

Private equity funds should consider how their existing and future foreign investors might implicate the CFIUS process for future U.S. investments. If CFIUS jurisdiction is triggered, funds will need to consider numerous questions regarding possible CFIUS action ahead of an acquisition, including whether CFIUS would have national security concerns, whether it would be prudent to seek CFIUS approval ahead of closing, and whether pre-closing notification to CFIUS would be required under the FIRRMA amendments.

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