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Private equity funds, venture capital funds, hedge funds, and other investment funds receive carve-outs from expanded CFIUS jurisdiction

3 August 2018

The Foreign Investment Risk Review Modernization Act (FIRRMA), included in the reconciled Conference Report of the FY19 National Defense Authorization Act, substantially expands the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS), but exempts from CFIUS's review certain foreign investments made through U.S. investment funds. FIRRMA also includes a parallel exemption from the requirement to submit so-called declarations (i.e., short form notices) for certain foreign investments. These investment fund carve-outs, the product of sustained industry engagement, provide a clearer set of rules for determining which minority foreign investments through U.S. funds will not be subject to CFIUS's review.

The Conference Report has passed the House of Representatives and the Senate, and President Trump is expected to sign the bill into law.

For a broader overview on FIRRMA, please see our client alert published on 30 July.

A. Current law

Under the current version of the Defense Production Act of 1950 (DPA), which FIRRMA revises, CFIUS's jurisdictional hook is based on whether the foreign investor could "control" the underlying U.S. business. The DPA exempts from CFIUS's jurisdiction certain foreign investments if the foreign person holds 10 percent or less of the outstanding voting interest in the U.S. entity and the investment is made solely "for the purpose of passive investment." Foreign persons who invested indirectly in U.S. businesses as limited partners in a U.S. investment fund traditionally have been considered to lack the ability to control such businesses because the funds were typically structured as U.S. limited partnerships controlled by a U.S. general partner. But certain U.S. limited partnerships in which the foreign limited partners' rights, including membership on the funds' investment committees, were not so limited, provided more challenging exercises in determining whether the foreign limited partners could indirectly control the U.S. portfolio companies.

B. Conference report text

i. Covered transactions and "other investments"

FIRRMA expands the types of transactions that will fall under CFIUS's jurisdiction (i.e., "covered transactions") to include:

1) any merger, acquisition, or takeover (including those carried out via joint venture) by or with any foreign person that could result in foreign control of any U.S. business;
2) certain transactions with foreign persons involving real estate in close proximity to air or maritime ports, military installations, or other sensitive national security facilities;
3) "any other investment" regarding critical infrastructure, critical technologies, or sensitive personal data of U.S. citizens;
4) changes to the rights of a foreign investor in a U.S. business if a change would result in foreign control of the U.S. business or an investment described in (3) above; or
5) any transaction, transfer, agreement, or arrangement intended to evade CFIUS review.

The "other investments" category of covered transactions is a new trigger for CFIUS and, importantly, does not require that the foreign investor have any ability to control the U.S. business. These "other investments" will include any direct or indirect investment by a foreign person (a term that CFIUS will define by regulation) in a U.S. business that: i) owns, operates, manufactures, supplies, or services critical infrastructure; ii) produces, designs, tests, manufactures, fabricates, or develops one or more critical technologies; or iii) maintains or collects sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security, <u>if</u> the investment would afford the foreign person:

1) access to "material nonpublic technical information" in the possession of the U.S. business that relates to certain critical infrastructure or critical technologies ("financial information regarding the performance of a U.S. business" is exempted);
2) membership or observer rights on the board of directors or equivalent body of a U.S. business, or the right to "nominate" an individual to such a body; or
3) any involvement in "substantive decision making," except the voting of shares, relating to certain personal data, critical technologies, or critical infrastructure.

ii. <u>Exceptions for investment funds</u>

The Conference Report **<u>excludes</u>** from the "other investments" category of covered transactions any indirect investments in a U.S. business by a foreign person through an investment fund that affords the foreign person (or a designee) membership as a limited partner or equivalent on an advisory board or committee of the fund[1] if:

1) the fund is managed exclusively by a general partner, a managing member, or an equivalent;
2) the general partner, managing member, or equivalent is not a foreign person;
3) the advisory board or committee on which the foreign person sits does not have the ability to approve, disapprove, or otherwise control investment decisions of the fund or decisions by the general partner, managing member, or equivalent related to entities in which the fund is invested;
4) the foreign person does not otherwise have the ability to control the fund, including the authority: to approve, disapprove, or otherwise control investment decisions of the

[1] Although this exception excludes from the category of "covered transaction" investments that meet factors (1)-(6) in Section B(ii), a foreign limited partner's indirect investment in a U.S. business, through an investment fund, might still constitute a "covered transaction" if the foreign investor has the power to "control" the U.S. business.

fund; to approve, disapprove, or otherwise control decisions made by the general partner, managing member, or equivalent related to 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;

5) the foreign person does not have access to "material nonpublic technical information" as a result of its participation on the advisory board or committee; and
6) the investment "otherwise meets the requirements" of this section (e.g., the foreign person is not a member of the US. business's board of directors).

For purposes of factors (3) and (4) above, any waiver of a potential conflict of interest, waiver of an allocation limitation, or a similar activity, does not constitute "control of investment decisions of the fund or decisions relating to the funds portfolio companies," unless CFIUS determines that there are "extraordinary circumstances."

This investment fund carve-out may not always be available. For example, a number of funds establish a general partner or managing member offshore and therefore would not satisfy factor (1). Also, in some funds, limited partners do have access to material nonpublic technical information, and therefore factor (5) would not be satisfied. In addition, it is likely that certain funds, such as some special purpose vehicles, funds-of-one, and separately managed accounts, may not satisfy factor (4), as the foreign person may retain the ability to "control the fund."

Nonetheless, this carve-out both provides a much clearer set of standards for determining whether a U.S. investment fund's investment in a U.S. business will subject its foreign limited partners to CFIUS's jurisdiction and also should be available to a large number of funds.

Mandatory declarations

Under current law, all filings with CFIUS are voluntary. Under FIRRMA, however, parties to certain types of covered transactions (to be prescribed by regulations promulgated by CFIUS) must file mandatory declarations (i.e., short form notices) with CFIUS. Mandatory declarations will be required when a transaction involves the direct or indirect acquisition by a foreign person of a "substantial interest" in a U.S. business engaged in critical infrastructure, critical technologies, or sensitive personal data of U.S. citizens when a foreign government has a "substantial interest" in the foreign person.

An investment will not be considered a "substantial interest," however, if it is excluded by the investment fund carve-out described above or if it grants less than a 10 percent voting interest to the foreign person. Waivers of this declaration requirement are available if the foreign person has a history of cooperation with CFIUS and shows that the investments are not directed by a foreign government. FIRRMA also grants CFIUS the authority to mandate declarations for foreign investments in U.S. businesses involved in critical technologies.

Investment funds are not required to file these new mandatory declarations for certain transactions. In another significant carve-out, parties to transactions are exempted from submitting these declarations where an investment fund is managed exclusively by a general partner or managing member who is not a foreign person, and the fund satisfies, with respect to any foreign person with membership as a limited partner on an advisory board or a committee of the fund, the criteria specified in (3) and (4) above in "Exceptions for Investment Funds." In

essence, this provision is intended to largely mirror the "any other investment" carve-out for investment funds described above.

We will continue to monitor this space for developments. Please contact us if you have specific questions about FIRRMA's impact on your fund's investments.

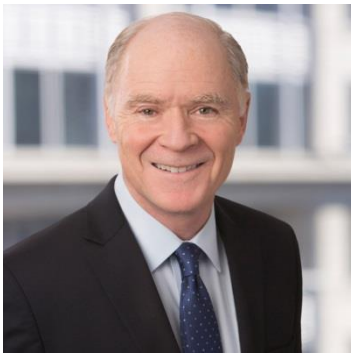
Contacts

Anthony Capobianco
Partner, Washington, D.C.
Tel +1 202 637 2568
anthony.capobianco@hoganlovells.com

Lourdes Catrain
Partner, Brussels
Tel +32 2 505 0933
lourdes.catrain@hoganlovells.com

Brian Curran
Partner, Washington, D.C.
Tel +1 202 637 4886
brian.curran@hoganlovells.com

Aline Doussin
Partner, London
Tel +44 20 7296 2961
aline.doussin@hoganlovells.com



Robert Kyle
Partner, Washington, D.C.
Tel +1 202 637 5494
robert.kyle@hoganlovells.com

Warren Maruyama
Partner, Washington, D.C.
Tel +1 202 637 5716
warren.maruyama@hoganlovells.com

Beth Peters
Partner, Washington, D.C.
Tel +1 202 637 5837
beth.peters@hoganlovells.com

Bryan Ricapito
Partner, Washington, D.C.
Tel +1 202 637 5481
bryan.ricapito@hoganlovells.com

Robert Welp
Partner, Northern Virginia
Tel +1 703 610 6119
robert.welp@hoganlovells.com

David Winter
Partner, Washington, D.C.
Tel +1 202 637 6511
david.winter@hoganlovells.com

Roy Liu
Counsel Washington, D.C.
Tel +1 202 637 4837
roy.liu@hoganlovells.com

Ari Fridman
Senior Associate, Washington, D.C.
Tel +1 202 637 5449
ari.fridman@hoganlovells.com

Zachary Alvarez
Associate, Washington, D.C.
Tel +1 202 637 6559
zachary.alvarez@hoganlovells.com

Jordan Movinski
Law Clerk, Washington, D.C.
Tel +1 202 637 6513
jordan.movinski@hoganlovells.com