# Foreign Investment and Export Control Reform Update (Part 2 of Series)

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The Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA"), which was signed into law by President Trump on August 13, 2018 as part of the omnibus John S. McCain National Defense Authorization Act for Fiscal Year 2019 ("NDAA"), expands the jurisdiction and ability of the Committee on Foreign Investment in the United States ("CFIUS") to review and restrict "covered" transactions on national security grounds. For an overview of the NDAA, please see Part 1 of this series.

Parties that engage in transactions pursuant to which a foreign entity would invest, directly or indirectly, in a U.S. business need to be cognizant of how such a transaction might be viewed by CFIUS following the implementation of FIRRMA. This includes private equity and venture capital funds, startup companies contemplating a financing, sovereign wealth funds, and real estate investors. In particular, companies and funds that operate in industries likely to be impacted by FIRRMA, such as technology and life sciences, prepare for the implementation of FIRRMA.

## Expansion of Transactions Subject to CFIUS Review

Under the prior CFIUS regime, CFIUS could only review transactions that resulted in foreign "control" over a U.S. business. Under FIRRMA, in addition to certain types of real estate transactions by foreign persons involving sensitive locations, CFIUS now has the authority to review transactions that involve any "**other investment**" by a foreign person in any U.S. business that:

- 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 U.S. citizens that may be exploited in a manner that threatens national security.

## Which "Other Investments" Trigger CFIUS Review?

Under FIRRMA, CFIUS has jurisdiction over any investment by a foreign person in a U.S. business involved in critical infrastructure, critical technologies, or sensitive personal data that affords such foreign person:

- access to any material nonpublic technical information in the possession of the U.S. business;
- membership or observer rights on the board of directors or equivalent governing body of the U.S. business or the right to nominate an individual to a position on the board of directors or equivalent governing body; or
- any involvement, other than through voting of shares, in substantive decision-making of the U.S. business.

FIRRMA defines material nonpublic information as information that is not in the public domain and that provides knowledge about critical infrastructure or is necessary to develop critical technologies. Notably, it does not include financial information regarding the performance of a U.S. business.

FIRRMA defines an "investment" to include the "acquisition of contingent equity interest" (subject to further definition in forthcoming regulations). Consequently, it would appear that debt financing, if convertible into equity, or option grants may now subject a transaction to CFIUS review.

An investment in a U.S. business, other than a purely passive financial investment, with no other rights, may be subject to CFIUS review.

Venture capital and private equity funds and companies entering new financing rounds should be cognizant of this risk when structuring their funds and/or deals.

## Carve Out for Certain Private Equity and Venture Capital Investments

FIRRMA includes a carve out for certain indirect investments made by foreign persons through private equity and venture capital funds even if the fund itself is not a purely passive investor in the relevant U.S. business. Specifically, an indirect investment by a foreign person in a U.S. business through an investment fund that affords the foreign person (or a designee of the foreign person) membership as a limited partner or equivalent on an advisory board or a committee of the fund will not be subject to CFIUS review if and only if it meets the following criteria (to be further defined in forthcoming regulations):

1. The fund is managed exclusively by a general partner or an equivalent;
2. The general partner or equivalent is not a foreign person;
3. 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 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; and
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.

## Private Equity and Venture Capital Considerations

While the carve out described above may take many private equity and venture capital investments outside the scope of CFIUS review, examples of common scenarios that may still trigger a review include:

- A foreign investor on the advisory board of a fund with access to information that may be considered material nonpublic technical information. This may be more common, for example, in funds focused on investing in technology;
- A foreign limited partner on a limited partner advisory committee, where the advisory committee is required to approve of certain fund decisions, such as the replacement of key personnel that make investment decisions;
- A fund with foreign investors and a foreign manager making investments in U.S. businesses involved in critical infrastructure, critical technologies or sensitive personal data;
- Certain investment structures, such as “funds-of-one”, where a foreign investor may have more control than a passive limited partner typically would;
- The right for a fund (that does not fall within the carveout above) to elect a board member;
- Financing transactions that include convertible debt financing by a fund that falls outside the carveout described above.

Funds that are formed offshore will not necessarily automatically be treated as foreign persons for the purposes of FIRRMA, depending on how the new regulations integrate existing concepts with FIRRMA direction. Under current regulations, an entity that demonstrates that a majority of the equity interest in such entity is ultimately owned by U.S. nationals would not be considered a “foreign entity.” Additionally, a “foreign entity” may not be considered a “foreign person” if no foreign national, foreign government or foreign entity has the ability to exercise control over it. CFIUS regulations to implement FIRRMA may narrow that interpretation significantly, in keeping with the very narrow carveout which FIRRMA provides for investment funds.

It is also still unclear whether certain specific scenarios could lead to CFIUS review, such as if the general partner of a fund is an offshore limited partnership, but the LP’s general partner is a U.S. entity. Although more parties must consider whether their transactions may be subject to CFIUS review, it is also worth remembering that CFIUS scrutiny may not necessarily lead to difficulties for a deal other than delays with respect to timing and filing fees required.

## Conclusion

FIRRMA has already profoundly altered the planning required for identifying and selecting strategic partners, investors, and targets. Once the precise scope of the new regime’s jurisdiction are known, fund structuring, governance, and minority investment requirements must be carefully scrutinized for their ability to withstand CFIUS scrutiny, and a shift in investor, and target, expectations will be required.

Under the new regime, no matter its precise contours, CFIUS analysis and considerations will inevitably take on an early and prominent role in discussions. The number of transactions for which filings will be required will increase, resulting inevitably in extended transaction timelines and additional expense in many cases.

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