Client Alert | National Security / International Trade

CFIUS Reform Becomes Law: What FIRRMA Means for Industry

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The Foreign Investment Risk Review Modernization Act (FIRRMA) was signed into law today by President Trump. FIRRMA reforms and modernizes the Committee on Foreign Investment in the United States (CFIUS) review process and represents the first update to the CFIUS statute in more than a decade. We reported on **FIRRMA's key provisions** in July. In this Client Alert, we discuss FIRRMA's practical implications as well as provide useful context relevant to clients and industry.

The Reality of FIRRMA

- **"Modernization" is a euphemism for addressing concerns about Chinese investments.** While the Trump Administration has been firm in its messaging that FIRRMA is meant to "close gaps" between the transactions that CFIUS is currently able to review and transactions it currently cannot review despite them raising similar national security concerns, the reality is that those "gaps" largely pertain to particular Chinese investment trends: (1) real estate acquisitions in sensitive areas, (2) minority investments (particularly through private equity-type structures) that might not be controlling but that nonetheless provide access to sensitive information or technology of the target US business, (3) the increasing use of Chinese joint ventures into which US-origin technology is transferred, and (4) concerns that Chinese deals are being structured to circumvent CFIUS.

- **FIRRMA provides the general contours for CFIUS reform, but not the specifics.** To achieve broad-based support for FIRRMA among competing interests in Congress, the various US government members of CFIUS, and industry, many of the novel, difficult, or contentious issues were deferred to the regulation-writing process. Throughout FIRRMA—and particularly in the sections that expand the scope of "covered transactions" (i.e., transactions subject to CFIUS's jurisdiction)—numerous provisions state that they are "subject to regulations prescribed by the Committee." These references were often the short-term solution when inter-governmental negotiations around certain provisions in FIRRMA were either met with resistance (e.g., disagreement on which declarations must be mandatory) or were particularly challenging (e.g., defining "emerging technology"). As a result, the ultimate impact of many of FIRRMA's key provisions is not yet known and will not be known until CFIUS promulgates new regulations implementing FIRRMA.

- **In particular, the extent to which covered transactions will expand is unknown.** As mentioned above, the *purpose* of the new categories of covered transactions (i.e., (1) certain real estate transactions; (2) non-passive but non-controlling investments in US businesses involving sensitive personal data, critical infrastructure, or critical technology; (3) changes in a foreign investor's governance rights, even in the

absence of any new investment; and (4) attempts to evade) is largely to enable CFIUS to review additional types of Chinese investments. But the *effect* is that, unless these categories are somehow limited, FIRRMA would cover every transaction in these new categories—potentially tens of thousands each year. The negotiated solution appears to be deferring to CFIUS to "prescribe regulations … to limit the application of [transactions in (1) and (2) above] to the investments of certain categories of foreign persons." How broad or narrow those "categories of foreign persons" are—and what criteria CFIUS uses to define the categories—will be, in our view, among the most important aspects of the regulations implementing this new legislation.

- **Limitations on FIRRMA's scope will be driven in part by resource considerations.** As CFIUS develops its regulations, it will concurrently have to consider its resource needs, including additional staff, to implement the new law. FIRRMA creates the potential for a well-funded CFIUS by providing for authorized appropriations, a "CFIUS Fund," and filing fees. But whether, and when, these funds will materialize remains to be seen, as does how quickly funding can translate into additional cleared staff to handle a substantial increase in notified transactions. Thus, as CFIUS writes its regulations, including the all-important limitations on covered transaction categories (1) and (2), it will do so based on its expected funding and staffing levels. If funding and staffing remain scarce, we expect that by necessity the expansion of "covered transactions"—especially those subject to a mandatory filing—will be more limited.

Short-Term Effects on the CFIUS Filing Process

- **No significant immediate change to the requirements for the contents of a CFIUS notice.** While many of FIRRMA's provisions come into effect immediately upon enactment, the most significant changes to CFIUS's scope and structure will only take effect once the Secretary of the Treasury certifies that the regulations, systems, and resources are in place to implement them (or 18 months from the date of enactment, whichever is sooner). Therefore, in the short term, we do not expect any significant changes to the types of information that is required for a CFIUS notice.
- Of the provisions that will come into effect immediately upon enactment, most merely codify or clarify CFIUS's current internal practices. Only a few will directly impact the review process or the preparation of a CFIUS filing:
  - **Potentially longer timelines.** FIRRMA lengthens the initial review period by 15 calendar days (to 45 calendar days) and permits the Secretary of the Treasury, at the request of a lead agency, to add 15 calendar days at the back end of an investigation in "extraordinary circumstances." This will potentially add up to 30 calendar days to a single CFIUS cycle (from 75 calendar days to 105).
  - **Disclosure of more agreements with the notice.** FIRRMA formalizes CFIUS's increasing tendency to request *all* material agreements related to the transaction under review. So, for example, in addition to providing a copy of the stock purchase agreement, CFIUS may also require the parties to provide copies of any other side agreements (including partnership agreements) related to the transaction.
  - **Stipulations as to whether a transaction is "covered" or "foreign government controlled."** Under FIRRMA, parties may stipulate in their notices that their transaction is "covered" (i.e., subject to CFIUS review) and/or "foreign government controlled."

Long-Term Effects on the CFIUS Filing Process

- **Expansion of covered transactions will spur new filing requirements and systems.** As discussed above, a key change to CFIUS's scope is the expansion of covered transactions to include (1) certain real estate transactions and (2) non-passive, non-controlling investments in US businesses involving sensitive personal data, critical infrastructure, or critical technology (subject to the limitations on these new categories that CFIUS will impose through regulation). The roll out of these new categories of covered transactions will likely involve an overhaul of the information that CFIUS requires in the notices and the electronic systems that CFIUS uses to receive and communicate with parties on their notices. We understand that discussions are already underway within the Treasury Department as to what information should be provided in the filings and what electronic systems could be utilized to handle the expected increase in filings.

- **Mandatory declarations represent a big change.** Another key change to CFIUS's scope is FIRRMA's creation of "declarations"—essentially, abbreviated notices—and the requirement that certain declarations be mandatory. FIRRMA requires that declarations be filed for certain transactions in which a foreign government has a "substantial interest", and it permits CFIUS to establish mandatory declarations for other "critical technology" transactions (subject to certain exceptions for investment funds and potential waivers for some foreign-government investors). This is a notable change from the current process, which is generally voluntary. Given the potential commercial disadvantage to an investor subject to mandatory declarations, we expect that the criteria for exceptions and waivers will be highly important and, in certain transactions, will influence the transaction structures.

- **Potentially faster feedback from Treasury staff (and fees for expedited comments).** Once the Secretary of the Treasury certifies that sufficient regulations, systems, and resources are in place, Treasury Department staff will be required to provide comments on draft and formal filings, or accept the filings for review, within 10 business days (for those cases in which the parties stipulate that the transaction is a covered transaction). This is intended to expedite the process at the outset, but depending on how it is implemented, it may not have that effect (if, for example, multiple rounds of comments and responses ensue). FIRRMA also requires a study on the merits of "prioritization fees" (i.e., payments of fees to get comments faster).

General Trends—CFIUS Moving Forward

- **China.** As mentioned above, a key impetus for FIRRMA is to enable CFIUS to review additional types of Chinese investment. This impacts both investments directly by Chinese entities and investments by non-Chinese entities that might have significant ties to China (such as through supplier, customer, partnership, joint venture, research and development, or funding relationships). FIRRMA highlights key areas of concern: proximity to sensitive US government facilities, sensitive personal data, critical infrastructure, critical technology, and (while now addressed in export-control reform initiatives) technology transfers to China. We expect that state-directed and -funded investment in these areas will be particularly highly scrutinized. That said, CFIUS's analytical methodology is a case-by-case analysis of the threat, vulnerability, and consequences of the particular transaction under review, and FIRRMA does not change that. We expect that CFIUS will continue to clear Chinese transactions that do not present unresolvable national security concerns.

- **Private Equity.** In recent years, as the number and complexity of private equity investments has grown, as well as the diversity of limited partners in such investments, CFIUS has increased its focus on these investment structures. There are several aspects of FIRRMA that may be of particular interest to private equity funds and investors.

    - **Certain exemptions from the expansion of covered transactions involving non-controlling, non-passive investments.** FIRRMA contains a "clarification" for investment funds in the new "non-passive, non-controlling" category of covered transactions. Generally, indirect investment whereby a foreign person obtains a seat or observer rights on the board *of the US business* (where such business involves sensitive personal data, critical technology, or critical infrastructure) could fall under this new category of covered transactions. FIRRMA clarifies, however, that indirect investment through an investment fund in which the foreign person has a seat on an advisory board or committee *of the fund* would not fall under this new category, so long as (1) the fund is managed exclusively by a US general partner or equivalent; (2) the advisory board or committee does not have the ability to control investment decisions of the fund or decisions made by the general partner or equivalent; (3) the foreign person does not otherwise have the ability to control the fund; and (4) the foreign person does not have access to material nonpublic technical information as a result of its participation on the advisory board or committee.

    - **Exclusions from certain mandatory declarations.** There are two potential carve-outs from mandatory declarations for certain private equity structures. Each is premised upon exclusive management of the fund by a US general partner and the inability of limited partners to control investment decisions or otherwise control the fund. The regulations will need to more precisely define these carve-outs.

    - **Change in rights as a covered transaction.** A feature of FIRRMA that has not attracted much attention, but that could have far-reaching effects, is the new category of covered transactions involving changes in

the rights that a foreign person has with respect to a US business. These changes could now be covered transactions if they result in foreign "control" (the current CFIUS standard) or meet the new "non-passive" standard with respect to US businesses involving critical technology, critical infrastructure, or sensitive personal data. This could impact investment funds if a change in the rights of limited partners—even absent any new investments in or by the fund—causes a foreign limited partner to obtain control of, or a non-passive interest in, the underlying US business.

- **Factors relevant to "control" and "non-passive" in the private equity context.** Separate from FIRRMA, CFIUS has been closely scrutinizing private equity structures in recent years. Some of the factors that CFIUS now considers in its analyses, and that funds and investors may wish to consider going forward, include:
    - How did the fund come about? Who initiated it?
    - Who were the anchor investors? How did such investors steer the investment strategy/focus of the fund?
    - Who are all of the limited partners?
    - What are all of the rights of the limited partners?
    - Which limited partners sit on advisory boards/investment committees, and what input do they have on such boards/committees? What powers do such boards/committees have?
    - To what extent can a limited partner suggest, review/opine on, and/or veto particular investments?
    - Beyond the particular fund involved in a transaction, what other funds does the private equity group have, how did those funds come about, and who are the anchor investors in them?
    - Who is the fund's general partner? How is it selected? How can it be removed/replaced?
    - Do any of the limited partners have interests in the general partner or in any other managers/advisors to the fund?
    - Will any of the limited partners have connections to the portfolio companies other than through the fund?

- **More resources for, and attention to, mitigation monitoring.** We expect that there will be more attention to mitigation monitoring. FIRRMA requires significantly more reporting to Congress on mitigation compliance and remediation, and this will likely increase the Committee's attention to these matters. We understand that already the Treasury Department—under its own initiative, as well as based on FIRRMA's directive to consider centralizing certain Committee functions within Treasury—is internally reorganizing to strengthen its oversight over CFIUS mitigation agreements. Where non-compliance is found, FIRRMA provides the Committee with new forms of remediation and eases CFIUS's ability to reopen its review of the transaction.

- **More robust non-notified process.** We understand that the Committee in general, and the Treasury Department in particular, is also strengthening its non-notified processes to more quickly and effectively identify transactions of concern that have not been filed for review. FIRRMA endorses the centralization of these functions within Treasury. This could increase the risk that CFIUS will request or self-initiate reviews of transactions that have not been voluntarily filed or declared.

- **Potential filing fees.** FIRRMA authorizes CFIUS to impose filing fees (there were none previously). Under FIRRMA, the fees—or the formula for determining the fees—will be set by the forthcoming regulations, but the fees may not exceed the lesser of one percent of the value of the transaction or $300,000 (adjusted for inflation). CFIUS must base the fees on the value of the transaction, taking into consideration factors such as the expenses of the Committee and the effects of the fee on small business concerns and foreign investment.

- **Allied engagement.** While the CFIUS process remains confidential under FIRRMA, FIRRMA does allow for greater information sharing with US state and local governments and foreign allied governments. The permission to share information with foreign allied governments, and FIRRMA's instruction that CFIUS should establish a formal process to do so, reflect a broader US government initiative to assist and incentivize partner countries to strengthen their own investment review mechanisms and pursue reviews of transactions of interest to the US government. Reforms have recently been enacted, or are being actively considered, in the EU, UK, Canada, Australia, and Japan, among others, and there is growing awareness and interest in investment-security issues worldwide. Already, the US, EU, and Japan have formally agreed to engage on investment security with a view to cooperation, information exchange, and potential coordination. With respect to specific transactions, the increasingly close collaboration on investment-security matters among governments means that in the future certain transactions could face (somewhat) coordinated review across multiple jurisdictions. The potential harmonization of investment security review processes is an area to watch.

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