Governance Implications of CFIUS Reform for US Investment Funds With Foreign Investors

10 / 30 / 18

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

Four Times Square
New York, NY 10036
212.735.3000

1440 New York Ave., N.W.
Washington, D.C. 20005
202.371.7000

In August 2018, President Donald Trump signed the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA),[1] which significantly reformed national security reviews by the Committee on Foreign Investment in the United States (CFIUS). Among FIRRMA's substantive and procedural reforms are codification of several existing CFIUS regulations and practices; expansion of the scope of CFIUS jurisdiction to cover certain noncontrolling investments; and establishment of mandatory filings for certain transactions.[2]

One of FIRRMA's notable provisions provides special treatment for indirect foreign investments undertaken through U.S.-managed investment funds meeting certain qualifications discussed below. Pursuant to this provision, such indirect investments will not be subject to CFIUS' expanded jurisdiction over noncontrolling investments in U.S. businesses involved with critical technology, critical infrastructure or personal information of U.S. citizens. As a result, such investments are also not subject to mandatory declarations to CFIUS.

On October 10, 2018, CFIUS issued interim regulations addressing the special treatment of investments through U.S.-managed investment funds.[3] Critically, these interim regulations provide details on how U.S.-managed funds will — or will not — be exempted from FIRRMA's expanded jurisdiction and mandatory declarations when such funds include foreign limited partners.

For all investment funds, mandatory CFIUS filings could have significant effects on the timing and viability of U.S. technology investments. Longer term, once final CFIUS regulations are issued, funds with investments from sovereign wealth funds or other foreign government-controlled investors will also have to consider the implications of mandatory declarations for investments in critical infrastructure businesses or companies that collect U.S. personal information. To avoid these issues, fund sponsors should consider whether they qualify for special treatment under FIRRMA and the interim CFIUS regulations.

Background on FIRRMA Pilot Program

The interim CFIUS regulations establish a FIRRMA-authorized pilot program for mandatory declarations (five-page overviews) of both controlling and noncontrolling foreign investments in U.S. businesses that develop or produce certain export-controlled technologies specifically for use in one or more of 27 enumerated industries. After receipt and acceptance of a mandatory declaration, CFIUS has 30 days to respond, either by clearing the subject transaction or by seeking submission of a full CFIUS notice to enable further review.

Mandatory CFIUS filings under the pilot program (and eventually, under final FIRRMA regulations) will be a significant departure from past CFIUS practice, when notices to CFIUS were voluntary. Noncompliance with this new requirement can have severe consequences, as CFIUS can impose civil penalties up to the value of the transaction.

[1] The text of FIRRMA is available here.

[2] See our August 6, 2018, alert, "US Finalizes CFIUS Reform: What It Means for Dealmakers and Foreign Investment," for an overview of the key provisions of FIRRMA.

[3] For a full description of all key aspects of the interim regulations, see our October 11, 2018, alert, "CFIUS Pilot Program Expands Jurisdiction to Certain Noncontrolling Investments, Requires Mandatory Declarations for Some Critical Technology Investments."

Governance Implications of CFIUS Reform for US Investment Funds With Foreign Investors

Qualifications for Special Treatment

To qualify for special treatment under the pilot program, an investment by a foreign person via an investment fund must meet the following standards under the interim CFIUS regulations:

- The fund must be an entity that either is an "investment company," as defined in Section 3(a) of the Investment Company Act of 1940, as amended (40 Act), or would be an investment company but for exemptions provided in Sections (3)(b) or 3(c) of the 40 Act.[4] Notably, the fund is not required by the 40 Act, the interim CFIUS regulations or FIRRMA to be legally domiciled or headquartered in the United States.
- The fund must be managed exclusively by a general partner, managing member or equivalent who is not the foreign investor. (Under a provision of FIRRMA not yet implemented, no foreign person will be permitted to serve as general partner, managing member or equivalent; we expect this provision to be reflected in the final FIRRMA regulations.)
- The foreign investment in the fund must entitle the foreign investor or its designee membership in the fund's advisory board or similar committee.[5]
- Neither the foreign investor, acting unilaterally, nor the fund's advisory board may have the right to approve, disapprove or otherwise control (i) investment decisions of the fund or (ii) decisions by the general partner relating to the fund's portfolio companies.
- The foreign investor must not otherwise have the ability to control the fund, including the unilateral right to select, dismiss, prevent dismissal of or determine the compensation of the general partner. Even before the enactment of FIRRMA, CFIUS disregarded the U.S. domicile and headquarters of "captive" U.S. investment funds controlled by foreign owners and has recommended in some instances that such investments be blocked.[6]
- Membership on the advisory board must not give the foreign investor access to material nonpublic technical information relating to critical technologies; this prohibited information does not include portfolio companies' financial information.

The interim regulations do not, except in extraordinary circumstances to be determined by CFIUS, consider a foreign investor's waiver of potential conflicts of interest, allocation limitations or similar activities to be a control decision for purposes of the qualifications listed above.

Implications for Fund Governance

Typically, foreign investments in public registered investment funds do not implicate the pilot program's mandatory declaration requirement or require consideration of the special treatment provisions, because investors in such funds are generally not afforded the level of governance or information rights that would trigger CFIUS jurisdiction under FIRRMA. One cannot assume, however, that CFIUS jurisdiction and the pilot program will never apply to public investment funds, especially those with unusual governance provisions.

More frequently, sponsors of private investment funds may be faced with the prospect of mandatory CFIUS filings by (or perhaps even on behalf of) their foreign investors, because the funds' limited partnership agreements, side letter agreements and similar fund formation documents may explicitly or implicitly grant foreign investors rights beyond those consistent with qualification for special treatment by CFIUS. Examples of governance provisions that may give rise to this concern, especially in the context of advisory boards dominated or heavily influenced by large non-U.S. investors, include the following:

- **Advisory Board Approval of ESG Provisions.** Many fund agreements authorize the advisory board to approve exceptions to the fund's investment guidelines, including acquisitions of portfolio companies that may have "environmental, social and governance" (ESG) attributes of interest to the investors.
- **Advisory Board Approval of Key Fund Managers.** Advisory boards are also frequently tasked with approving replacements to key persons following a departure, and such replacement individuals become the individuals responsible for the investment decisions of the fund.
- **Removal and Replacement of General Partners.** The documentation governing private funds commonly provides for the right of a certain percentage of investors to remove the general partner and choose a replacement. Such arrangements reflect not only commercial norms for private funds but also requirements emanating from nonconsolidation analyses with respect to the treatment of the fund for the sponsor's accounting purposes.

[4] Except for most public funds, which are less likely to fall within the scope of the pilot program, as discussed below.

[5] Of note, neither FIRRMA nor the interim regulations offers special treatment to investors in funds that do not have advisory boards. Thus, under the interim regulations, the absence of an advisory board would by their letter preclude application of the exemption. Alternatively, CFIUS may choose not to treat investments through such funds as foreign, thus removing any CFIUS requirements.

[6] See, for example, President Trump's 2017 order blocking the acquisition of Lattice Semiconductor Corporation by Canyon Bridge Fund I.

Governance Implications of CFIUS Reform for US Investment Funds With Foreign Investors

- **Investor Ownership of Managers and General Partners.** Certain large institutional investors regularly negotiate the acquisition of stakes in the manager of a private fund when considering a fund commitment and as a result become significant owners of the manager entities (and sometimes also of the general partner entities).
- **Funds of One.** Certain large institutional investors prefer to structure their exposure to strategies offered by a fund manager through a proprietary "Fund of One" vehicle that is dedicated to that investor and that may invest alongside a flagship vehicle of a manager.[7] Such investors, especially those committing a significant amount of capital through a Fund of One structure, may thereby acquire significant effective decision-making rights with respect to both the flagship fund and the related Fund of One entity.

To benefit from CFIUS' special treatment for investment funds under both the pilot program and the eventual expansion of mandatory declaration requirements under final CFIUS regulations, fund sponsors should consider whether the rights granted under current and future fund agreements can be written to limit the rights of foreign investors in the funds. Currently, fund managers are considering a number of alternative governance protocols and procedures, some of which may be applicable to this situation.

Finally, to address the fact that CFIUS' special treatment extends only to funds in which investors are entitled to serve on an advisory board, fund sponsors should carefully consider how such committees are structured and the rights associated with membership on those committees.

[7] Co-investment rights, even if outside the context of a Fund of One vehicle, may also weigh on CFIUS' assessment of the influence or control of the foreign investor.

Contacts

CFIUS

Michael E. Leiter
Partner / Washington, D.C.
202.371.7540
michael.leiter@skadden.com

Ivan A. Schlager
Partner / Washington, D.C.
202.371.7810
ivan.schlager@skadden.com

Donald L. Vieira
Partner / Washington, D.C.
202.371.7124
donald.vieira@skadden.com

Jonathan M. Gafni
Counsel / Washington, D.C.
202.371.7273
jonathan.gafni@skadden.com

Daniel J. Gerkin
Counsel / Washington, D.C.
202.371.7194
daniel.gerkin@skadden.com

Malcolm Tuesley
Counsel / Washington, D.C.
202.371.7085
malcolm.tuesley@skadden.com

Investment Management

John M. Caccia
Partner / New York
212.735.7826
john.caccia@skadden.com

Heather Cruz
Partner / New York
212.735.2772
heather.cruz@skadden.com

Michael K. Hoffman
Partner / New York
212.735.3406
michael.hoffman@skadden.com

James M. Schell
Partner / New York
212.735.3518
james.schell@skadden.com