Under New CFIUS Rules U.S. Private Equity Funds Must Exercise Caution in Accepting Foreign Investment

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On February 13, 2020 new regulations of the Committee on Foreign Investment in the United States ("CFIUS") went into effect. These rules spell out changes in CFIUS jurisdiction and practice made by the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA"). Until the passage of FIRRMA, CFIUS jurisdiction only extended to foreign investments that resulted in a foreign party gaining control (albeit loosely defined) of a U.S. business with national security implications. Notification to CFIUS of such a transaction was optional and was undertaken primarily by parties wishing to receive advance clearance and a safe harbor from later government review or possible unwinding of the investment.

FIRRMA expands CFIUS jurisdiction to encompass even non-controlling foreign investments in U.S. businesses with certain advanced technology, critical infrastructure or sensitive personal data, or in U.S. real estate located near military or security related sites.[1] It also mandates notification to CFIUS of investments in U.S. businesses that produce, design, test, manufacture, fabricate or develop products or technologies for many sensitive industries where the foreign investor would have access to critical emerging or foundational technology. Notification to CFIUS of investments with foreign government involvement is also required in certain circumstances.

Private equity funds accordingly must take care that participation by foreign persons in the fund do not render the fund itself a "foreign person" for CFIUS analysis. If it were to be treated as a foreign person, a wide range of small, non-controlling investments by the fund could potentially be subject to CFIUS jurisdiction, and, perhaps more significantly, investments in designated sensitive industries would trigger mandatory filings. To remain a U.S. entity and avoid these pitfalls, a fund must be certain that:

- It is managed by a General Partner ("GP") who is not a foreign person or controlled by a foreign person;
- No foreign Limited Partner ("LP"), or any advisory committee on which the foreign LP serves, has the authority to approve, disapprove or otherwise control investment decisions of the fund, or decisions made by the GP related to the entities in which the fund is invested; and
- No foreign LP has the unilateral right to control the appointment, dismissal or compensation of the GP, or otherwise has the ability to exercise control over the GP or the fund.

Even where the fund is not treated as a foreign person, to avoid an investment in a portfolio company triggering the requirement for a mandatory CFIUS filing care must still be taken to limit the access by foreign LPs to material non-public information of the portfolio company. In addition, foreign LPs may not be accorded membership or observer rights on the board of directors nor have any involvement in the substantive decision-making of the portfolio business regarding sensitive personal data of U.S. citizens or the use of critical technology or infrastructure.

FIRRMA authorizes CFIUS to impose severe penalties on companies that fail to make mandatory filings. Receiving advice from skilled counsel when organizing a fund, and especially when contemplating the acceptance of foreign participation, is thus prudent.

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[1] For additional information on the new CFIUS real estate regulations, see: CFIUS Expands Its Coverage of Foreign Investments in U.S. Real Estate