The Deal WEBCAST

Structuring M&A and Private Equity Deals: The CFIUS Challenge in Getting Deals Done

Presented By

The regulatory body known as The Committee on Foreign Investment in the U.S, or CFIUS, is a lot of things to a lot of people, but for very few investors has it ever been well understood and simple to navigate.

CFIUS, which focuses on reviewing M&A and other investment transactions that result in foreign control of a U.S. business and have the potential to affect U.S. national security, has for many years appeared to feel like a moving target for market participants.

Filing for approval with the regulator is usually voluntary, but if transaction parties that should have filed with CFIUS don't do so, it can create significant headaches for dealmakers later. Meanwhile, figuring out what exactly the committee considers a national security concern is more art than science, as it typically has not disclosed the items that go into its analyses.

Advisers that have handled several CFIUS reviews can tell you some of the basic triggers: acquisitions and investments by foreign entities of/in a U.S. business that either contracts with U.S. government agencies or that possesses or controls "critical technologies" or "critical infrastructure".

> **"Under the new rules, the focus on critical technology, critical infrastructure and sensitive personal data really hit at the core of the hot sectors."**

But the subject of scrutiny in any specific case has traditionally been left up to CFIUS's interpretation. For example, in 2012, CFIUS insisted a Chinese-owned wind farm developer unwind a recent deal for four wind farm projects in Oregon without specifying the precise national security risk posed by the transaction – a press release regarding the CFIUS decision released by the U.S. Department of the Treasury indicated it may have had something to do with the wind farm's proximity to restricted air space at a U.S. Naval facility.

"CFIUS is one of the trickier [regulators] to deal with for a couple of reasons, and one is because it is probably the least clear," said Alex Darden, a partner of private equity firm EQT Partners AB, on a September web panel hosted by The Deal in partnership with global law firm Pillsbury Winthrop Shaw Pittman LLP. "It impacts institutions in different ways that aren't always obvious to certain parties within a transaction."

As a result of this opaqueness and complexity, many investors who face the question of whether a certain transaction will lead them down a path to CFIUS intervention have opted to simply avoid such deals, Darden said.

"From my standpoint, in many cases – and somewhat as an American as opposed to

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just as an investor — it's a situation that can lead to the sale or transfer of an asset to someone who is not the optimal owner because there is a set of foreign investors who exempt themselves out from pursuing certain assets because they are at a competitive disadvantage versus certain American institutions," he said.

The ire directed at CFIUS by infrastructure investors such as EQT may be a relatively recent development that spawns from recent updates to the laws that guide what deals CFIUS is able to review.

Congress passed a piece of legislation called The Foreign Investment Risk Review Modernization Act, or FIRRMA, that was signed into law by President Donald Trump in 2018. The law expanded the jurisdiction of CFIUS and gave the government more power to look at certain kinds of transactions it felt it was unable to analyze in depth before.

The regulations implementing FIRRMA, which took effect in February 2020, also requires mandatory filing for deals involving critical U.S. technology, as well as those involving foreign government-owned investors investing in US businesses involved with critical technology, critical infrastructure or sensitive personal data.

"CFIUS and other regulators continue to operate under an innocent-until-proven-guilty mentality."

"Under the new rules, the focus on critical technology, critical infrastructure and sensitive personal data really hit at the core of the hot sectors," said Pillsbury partner Nancy Fischer. "The explosion of personal data and the ways in which all these new technologies leverage some sort of data really drives some of the focus from a CFIUS perspective."

The primary changes in CFIUS' power, and those that have garnered the greatest scrutiny, involve the expansion of its ability to look at any deals – aside from strictly passive investments that provide investors with no access to non-public technical information, board seats or business decision-making ability – involving "critical infrastructure" and "critical technology." Prior to the 2018 reform, the committee only had the authority to review deals that could result in "foreign control" of a U.S. business.

FIRRMA also broadened the definition of "critical technology" to include emerging technologies, a development that placed a spotlight on the ever-expanding U.S. venture capital industry.

Pillsbury partner Patrick Hovakimian contended, however, that despite the seemingly obvious targets of the reform – Chinese and Russian investments in businesses developing new technologies within the U.S. – CFIUS and other regulators continue to operate under an innocent-until-proven-guilty mentality.

"FIRRMA expanded CFIUS' jurisdiction, there are no two ways about it," he said. "Yes, there are certain countries that will still raise red flags, but I say that and also say in the same breath that neither the statute nor the regulations have any presumptions in them. There's no sort of heightened scrutiny in there. I'm confident that every deal is judged and looked at on a case-by-case and contextual basis."

Concerns that the reforms add another layer of bureaucracy to getting deals done and put into question capital coming from countries that are "unequivocally a geopolitical and strategic ally of the U.S.," are understandable, Hovakimian added. But he argued that these consequences were not indicative of a broader shift in the government's views on foreign investments.

"I can't speak for the government, but I can say it has been the policy of every U.S. administration going back to at least the 70s to encourage direct foreign investment," he explained. "I don't think that's changing. I think the regulatory framework has been beefed up. And I think there are agencies that are looking at things intentfully and purposefully, but I don't think anything is a foregone conclusion."

Nevertheless, there are those in the tech investment community who wonder whether the recent reforms are a slippery slope.

Corporations are evolving in such a way that every company is becoming a tech company, Juniper Networks Inc. (JNPR) senior vice president of strategy and corporate development Kevin Hutchins said during the panel.

Overtime this will ensure that tech being developed today will become more and more pervasive, making any limitation on the capital sources driving that innovation a potential cause for alarm.

"After a little more than 18 months under the new, finalized regulations, market watchers are already witnessing some effects of the reforms. "

"What we're seeing now is all of a sudden people are trying to put investments more into spaces where previously people were thinking they were solved problems, like semiconductors," he explained. "Now capital wants to come into that very quickly, but in order to really be meaningful, you have to be able to get a lot of capital quickly. Where can you bring capital from? What returns is that capital seeking? It's a very interesting landscape right now that we're going to have to navigate because I don't think we're in a world where these technologies are going to become less important."

As the new tech becomes more and more critical, Hutchins said he expects to see more instances of regulators contemplating ways to better protect that technology.

"And that's going to force us more into limited sources of capital," he said. "As an acquirer, we're really interested in getting the best tech. That's what we want. We want to acquire the best technology. We want to deploy that in our marketplace. We want to work with whomever is actually getting those investments in market. And that's where this complexity starts to really become more of a challenge for us."

To be sure, CFIUS already has begun to flex its newfound muscles in ways that has pulled capital away from innovative companies. In April 2019, the committee forced Chinese investors to divest from healthcare startup PatientsLikeMe and LGBTQ dating app Grindr, each over suspected concerns of the businesses' collection of sensitive personal data. And in July, CFIUS provided an update to Congress on its scrutiny of foreign investment transactions of which it was never notified—including 117 in 2020 alone—sending a clear notice that no investment will go unchecked by the committee.

After a little more than 18 months under the new, finalized regulations, market watchers are already witnessing some effects of the reforms.

"There is a lot of Chinese capital going into Europe, there's been some press about that," said David Lam, a general partner at growth equity firm Atlantic Bridge Ventures. "We're definitely seeing that on the ground as some the Chinese capital is having a tougher time getting into the U.S."

Under President Joe Biden's administration, Lam said CFIUS appears better funded and more active, even with lower thresholds – both in terms of smaller transaction dollar size and foreign investment stake size –than his firm has seen in years' past.

"In the end, I think the question we're trying to balance here, and what the government is trying to balance is: How do you protect national security?" he said. "And fundamentally the question is, can you do that while also welcoming foreign direct investment?"

Foreign direct investments fuel jobs growth, funds innovations in the U.S. with foreign dollars and creates leverage in the system, Lam added. But he can also see the justifications for taking a closer look at certain industries that fall under the scope of critical technology and infrastructure.

"These sectors that have been laid out, especially AI, semiconductors, some software technologies and cybersecurity, are critical to national security," he argued. "I think there's a lot of reasonable focus on these sectors. I do think it slows transactions down, it does turn away capital. But it's all about really trying to strike that balance."

Where to draw the line is an enormous point of contention, however, according to DataRobot Inc. chief strategy officer and fellow panelist Sirisha Kadamalakalva.

For example, she admitted that cybersecurity in software and hardware applications today can pose an immense national security risk but pointed to discrepancies in recent CFIUS reviews that illustrate just how complex implementing protections against those risks can be.

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Kadamalakalva emphasized the oddity of CFIUS' scrutiny of Beijing-based PE firm Wise Road Capital Ltd.'s $1.4 billion pending acquisition of South Korea's Magnachip Semiconductor Corp. (MX).

"This is a company that is traded in the U.S., listed in the U.S., but it's a South Korean company with no operations, people or infrastructure in the U.S.," she explained. "Given Chinese semiconductor companies have not been able to acquire U.S. semiconductor companies, now they are focused on acquiring in the rest of the world, and CFIUS essentially has said 'Hey, this comes under purview, too,' even though there are no assets based in the U.S."

Some contend, however, that while transactions may receive greater scrutiny and take more time to complete, investors can successfully navigate these new hurdles. The key, even in industries where critical infrastructure such as semiconductors is at stake, is for transaction parties to understand and weigh the most important considerations carefully during the early stages of deal structuring.

"Even under the expanded jurisdiction that's provided in FiRRMA, deals can get approved," Pillsbury's Hovakimian said. "I do believe it's been the policy of the U.S. – and I don't anticipate it changing – to encourage foreign direct investment. It's just a matter of there are new threats, and the landscape is evolving every day. And the statutory and regulatory framework potentially has caught up with that and enabled the government to have more tools to scrutinize deals."

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