

## How FIRRMA Changes The Game For Tech Cos. And Investors

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(October 10, 2018, 4:08 PM EDT)

The Foreign Investment Risk Review Modernization Act of 2018, signed into law in August, will alter significantly how the Committee on Foreign Investment in the United States — the interagency body that reviews inbound investments from a national security perspective — conducts its work.[1] There are several headlines for emerging technology companies and the venture capital funds and others that invest in them.

For one, FIRRMA decisively extends CFIUS' jurisdiction beyond "controlling" investments to some decidedly minority investments in U.S. businesses, if such businesses' products or services relate to "critical technology," "critical infrastructure" or "sensitive personal information" of U.S. citizens. While "critical technology" is not fully defined in the new law, the term explicitly includes "emerging and foundational technologies."

FIRRMA also extends CFIUS' jurisdiction beyond direct investments, to reach some indirect foreign investments as well. Thus, the presence of foreign limited partners in venture or other investment funds can possibly trigger CFIUS review too. And foreign government investors specifically, whether direct or indirect, are subject to new procedural rules requiring more notice to CFIUS.

Going forward, then, emerging technology companies, and their prospective investors, must be mindful of whether investments are now subject to CFIUS jurisdiction, and if so, what the implications of such review may be.

### Noncontrolling Investments in Emerging Technologies

Direct equity investments by "foreign persons" into any business engaged in interstate commerce in the United States have long been subject to CFIUS review, to the extent that those investments involved actual or potential "control" over the U.S. business by the foreign investor.

The "control" criterion has been interpreted somewhat liberally, in that foreign investors with above 10 percent of a company's voting shares, together with, for an example, a board seat, might be deemed to satisfy "control" for CFIUS purposes. In other words, control in this context has not meant the investor must have complete or exclusive



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control, but rather to the ability to have some substantial influence on the management of a U.S. company.

The type of product or service the U.S. company offered has not been relevant to the jurisdictional question whether the transaction was subject to CFIUS review, although whether the committee is likely to conclude that an investment, on the merits, raises national security concerns very much depends, of course, on the nature of the U.S. business. Investments in advanced semiconductor technology may find a different reception by the committee compared with investments in paper products.

FIRRMA changes the jurisdictional framework. One of its most significant provisions extends CFIUS review to any investment that relates to a U.S. business owning or maintaining “critical infrastructure”; a business involved in the development, design or production of “critical technology”; or a business collecting or maintaining “sensitive personal data” of U.S. citizens, in the event that the investor acquires (in connection with the investment) “any material nonpublic technical information”; is granted membership or observer rights on any board of the business; or has “any involvement” in the decision-making of the business.

Put differently, whether an investment is subject to CFIUS review in the first place now depends in part on the nature of the U.S. business in question and the investor’s right to nonpublic information or ability to influence decision-making. For some types of businesses — specifically, those involving critical technology, critical infrastructure and sensitive personal data — any investment giving the investor any special insight into the business or influence on management may trigger jurisdiction.

FIRRMA’s definition of “critical technology” for these purposes includes, among other things, “[e]merging and foundational technologies.” Such a jurisdictional expansion is plainly important for emerging technology companies and their investors.

Yet the identification of “emerging and foundational” technologies that can now trigger expanded CFIUS review are not specified in FIRRMA. Rather, they will be identified by a new interagency body, composed of a subset of the same federal agencies that comprise CFIUS, instructed to run “a regular, ongoing interagency process to identify emerging and foundational technologies” that are “essential” to national security and thus subject to CFIUS review, a process likely to unfold over many months.

Which brings us to the crucial question: Which new technologies are likely to land in this set? While it is difficult to say at this early point, one might hypothesize that technologies relating to, for example, artificial intelligence, autonomous mobility, advanced manufacturing and robotics and advanced telecommunications, among others, may well be candidates.

FIRRMA does prescribe the general methodology according to which the interagency group is to identify such technologies, however, instructing that it is to consider publicly available information, classified information and information supplied by various government advisory committees. Notably, earlier versions of FIRRMA also required the interagency group to solicit public comments on the question as well — a provision not contained in the final version of FIRRMA enacted into law, though the interagency may well see fit to conduct notice-and-comment rulemaking in the absence of such a requirement. If so, emerging tech companies and their investors will likely seek to participate in the rulemaking process.



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Stepping back, FIRRMA reflects a balance between those who sought to restrict foreign investment further, especially with respect to new technology (which can threaten U.S. national security), and those who sought to prioritize foreign investment in the U.S. as important for economic growth, here again especially for new technology (the development of which is important for the U.S. economy). Accordingly, with respect to emerging and foundational technologies in particular, FIRRMA directs the new interagency group to consider the effects that controlling them “may have on the development of such technologies in the United States.”

This important provision suggests that if tighter controls would impede the development of an emerging and foundational technology in the U.S., particularly if such a result means the technology is developed elsewhere instead — which could compromise U.S. national security more than foreign investment in domestic development — that factor is to count against expanded CFIUS review over the new technology. Exactly how the interagency group considers this factor will be of special interest to emerging tech companies and their investors.

### **Fund Investments**

FIRRMA also takes the “direct” out of foreign investment review, providing for possible CFIUS jurisdiction over certain venture fund investments — in addition, that is, to direct investment by a venture fund into a portfolio company. Specifically, CFIUS’s jurisdiction will now extend to indirect investments in U.S. businesses implicating critical infrastructure, critical technology and sensitive personal information that give the fund’s LPs access to “material nonpublic technical information,” board membership or board observer rights, or a substantive decision-making role in the business.

Thus, the presence of foreign LPs in a venture capital fund, depending on the fund’s structure, can trigger CFIUS jurisdiction. FIRRMA contains an important carveout here, however. A foreign LP will not subject a fund investment to CFIUS jurisdiction if the fund is managed exclusively by a non-foreign general partner, the LP has no ability to control the fund’s investments and the LP does not, as a result of any advisory board membership, gain access to — here once again — “material nonpublic technical information.”

This exception is important for venture capital funds with foreign LPs and U.S. companies seeking fund investments, as it effectively provides a way to structure such investments without triggering CFIUS jurisdiction.

### **Foreign Government Investors**

Another of FIRRMA’s innovations is the possibility of fast-track review of transactions subject to CFIUS jurisdiction. That is, FIRRMA allows for “declarations” as an alternative to the full-fledged written “notices” that parties to a covered transaction now file.

These declarations will be shorter than notices measured by written pages submitted, and FIRRMA instructs the committee to provide a response to a declaration within a shorter number of days, too. In response to a declaration, the committee may notify the parties they should file a complete notice after all, or initiate a full review on the committee’s own initiative, or else clear the transaction. Parties may elect to file a declaration in hopes of obtaining quicker clearance.

But this same declaration is required — not elective at all — for investments by foreign investors subject

to “substantial influence” by a foreign government, and by natural extension to foreign governments as well. Here, for the first time, FIRRMA makes a CFIUS filing mandatory.[2] As with elective declarations, a declaration submitted by a party subject to substantial influence by a foreign government may lead the committee to require a full notice, review the transaction on its own or clear the transaction without more.

While FIRRMA leaves to CFIUS the specification of substantial influence for these purposes, the statute states that a government ownership of the foreign investment that amounts to less than a 10 percent voting share shall not be considered a substantial interest. FIRRMA also provides an exception for investment-fund investments that parallels the investment fund exception described above; a mandatory declaration will not be required for fund investments, even involving a foreign government LP, where the fund is managed exclusively by a U.S. GP, and the foreign LP has no control over the fund or its investment decisions.

### **Examples: FIRRMA and Venture Capital**

As noted, FIRRMA delegates to CFIUS the considerable task of filling in many of the new law’s important details. Most of FIRRMA’s core provisions will not become effective until new regulations are promulgated by CFIUS that further define core terms, and specify required new procedures.

Even so, it is possible to begin to outline the type of investment transactions likely to be subject to CFIUS review in the new regime, and likewise to anticipate what venture investments in particular may look like going forward. Consider the following simplified scenarios.

#### ***Scenario 1***

An early stage company is developing advanced drone technology for commercial purposes. The company has been funded by domestic angel investors. Now, seeking its first equity financing, the company receives a term sheet from a Chinese fund. In connection with the proposed financing, the Chinese investor will obtain the right to appoint a board observer with access to information concerning the portfolio drone company.

It seems extremely likely CFIUS would conclude it has jurisdiction to review the fund investment under the new regime. This is so given the nature of the company’s business, which would seem to constitute critical technology, and the fact that the foreign investor, through its board observer, will be deemed to have access to material nonpublic technical information concerning a technology that could pose a national security risk.

#### ***Scenario 2***

Suppose that the company described in scenario 1 instead receives a term sheet for a noncontrolling investment from a venture capital fund that also requests the right to appoint a board observer. While the venture capital fund includes foreign LPs, it is managed exclusively by a U.S. GP. The venture capital fund is structured such that the indirect foreign investors will have no ability whatsoever to control the fund’s investments, or the activities of any of its portfolio companies.

In addition, while the venture capital fund itself will have a board observer, the foreign LPs demonstrably will not have access to any material nonpublic technical information that may be obtained by the observer. As long as the preceding two statements are true, even with the presence of foreign

LPs in the venture fund and the nature of the company's business, it seems likely CFIUS would conclude this transaction is not subject to its review, given the foreign investors' passive role in the fund.

### ***Scenario 3***

Suppose again that the company described in scenario 1 instead receives a term sheet for a noncontrolling investment from a venture capital fund managed by a foreign GP that also requests the right to appoint a board observer. The venture capital fund includes both U.S. and foreign LPs. In this situation, whether the foreign LPs have the ability to control the funds, or have access to any material nonpublic technical information obtained by the observer, is not dispositive.

The presence of a non-U.S. GP takes this transaction out of FIRRMA's exception, excluding fund investments from jurisdictional investments in critical technology; that exception requires a nonforeign GP. CFIUS would seem likely to conclude that this transaction is subject to review.

### ***Scenario 4***

A late-stage food tech company uses artificial intelligence to ensure better food safety through monitoring and testing at all stages of the food supply chain. In advance of its proposed IPO, the company seeks additional financing. The company receives a term sheet led by a foreign investor. The foreign investor would require the right to appoint a board observer in connection with its investment. As a result, the foreign investor would have access to material nonpublic technical information in possession of the U.S. company.

Whether this transaction would fall within CFIUS' jurisdiction will likely turn on the stake the foreign investor would have in the company. On the one hand, a food tech company developing technology to be in turn used by food producers and distributors might not constitute critical technology including emerging and foundational technologies with a nexus to national security. To that extent, the transaction would not be covered as "any other investment" under FIRRMA's new jurisdictional rules.

On the other hand, if the foreign investor's stake were large enough, measured as a percentage of the company's total equity interest post investment, then the transaction would be subject to CFIUS review — under the new rules and old — anyway, on the grounds the foreign investor has the potential to exercise significant influence over the company's important matters.

### ***Scenario 5***

Suppose that a new company with the technology described in scenario 4 instead receives a term sheet for an investment from a venture capital fund that also requests the right to appoint a board observer. The fund is comprised of investments made by a number of foreign investors substantially influenced by their government, but happens to be managed by a U.S. GP.

The venture capital fund is structured such that the foreign investors will have no ability to control the fund's investments or the activities of any of its portfolio companies, and will not have access to any material nonpublic technical information. Assume the fund's investment would represent a 51 percent voting equity interest of the food tech company, post investment. Here, still more facts would likely be necessary to determine whether the transaction is covered,<sup>[3]</sup> and in any event CFIUS' forthcoming FIRRMA regulations providing guidance on this scenario (and variations on it) will be instructive.

## Summary

FIRRMA alters the ground rules governing foreign investment review. The new law extends CFIUS' jurisdiction to reach some investments beyond controlling investments; applies to indirect investments under certain circumstances; and in several ways modifies the processes according to which foreign investment review is conducted.

These changes are of special relevance to emerging technology companies and those who invest in them — especially given FIRRMA's emphasis on critical technology in general, and on emerging and foundational technologies in particular.

FIRRMA's full implementation will follow forthcoming regulations that will further specify many of the new law's central terms. In the meantime, it is apparent that FIRRMA's reforms bring important implications for venture investors, with respect to both the nature of and the structure of their investments.

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[1] Most of FIRRMA's provisions, including those discussed here, will become effective following the issuance of implementing regulations by CFIUS that will further specify FIRRMA's core terms and detail its processes. Those regulations will take at least months and perhaps as much as a year. A few provisions are effective immediately, however.

[2] FIRRMA also authorizes CFIUS, in its discretion, to require mandatory declarations by regulation for transactions involving critical technology.

[3] On the one hand, depending on additional background facts concerning the U.S. GP, this transaction might be viewed by some to be subject to CFIUS review, given the size of the investment by foreign investors. On the other hand, an independent U.S. GP with only passive LP investors may not constitute a foreign person buyer for CFIUS purposes at all, and even if it did, the size of the investment described above would likely matter.