

STRIKING THE RIGHT BALANCE: EXTENDING CFIUS
REVIEW TO PRIVATE EQUITY TRANSACTIONS

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I. INTRODUCTION

Foreign investment in the United States is a critical feature of the global economy, but many question whether the U.S. Government strikes the right balance between national security and open markets.¹ One mechanism for screening foreign acquisitions implicating national security is the Committee on Foreign Investment in the United States (CFIUS).² Its controversial approval of the Dubai Ports World acquisition in 2006 aroused public concern over potential vulnerabilities created by foreign acquisitions that increase foreign access to proprietary data and technology or increase foreign control over domestic infrastructure.³ The incident also triggered increased public scrutiny of CFIUS.⁴ On July 26, 2007, President George W. Bush signed into law the Foreign Investment and National Security Act of 2007 (FINSA), amending CFIUS's authorizing statute.⁵

Meanwhile, the economic landscape over the last several years created a perfect storm for corporate acquisitions engineered by private equity (PE) funds, with acquisitions reaching unprecedented levels in 2006–2007.⁶ After pooling investments into funds to acquire operating companies, PE firms manage these companies “for optimum cash flow generation” and then spin them off to realize returns for fund investors.⁷ This strategy makes government

1. See *Foreign Investment, Jobs, & National Security: The CFIUS Process: Hearing Before the Subcomm. on Domestic & International Monetary Policy, Trade, & Technology of the H. Comm. on Financial Services*, 109th Cong. 2 (2006) (statement of Rep. Pryce, Chairwoman, Subcomm. on Domestic & International Monetary Policy, Trade, & Technology of the H. Comm. on Financial Services) [hereinafter *The CFIUS Process*]; Alan P. Larson & David M. Marchick, *Foreign Investment & National Security: Getting the Balance Right*, Council on Foreign Relations, CSR No. 18, at 3, 6–7 (July 2006), available at <http://www.cfr.org/content/publications/attachments/CFIUSreport.pdf>; James A. Lewis, *New Objectives for CFIUS: Foreign Ownership, Critical Infrastructure, & Communications Interception*, 57 FED. COMM. L.J. 457, 476 (2005).

2. The Department of Defense (DoD) has promulgated regulations governing a subset of acquisitions concerning companies “eligible for access to classified information or award[s] of...classified contract[s].” DEP’T OF DEF., NAT’L INDUS. SEC. PROGRAM OPERATING MANUAL 2-1-1 (Feb. 28, 2006) [hereinafter NISPOM] (discussing CFIUS and the DoD regulations in section 2-310).

3. See Larson & Marchick, *supra* note 1, at 5; Lewis, *supra* note 1, at 472, 476.

4. See Larson & Marchick, *supra* note 1, at 5; Press Release, Dep’t of the Treasury, CFIUS Welcomes Dubai Ports World’s Announcement to Submit to New Review (Feb. 26, 2006), <http://www.treas.gov/press/releases/js4072.htm>; Press Release, Dep’t of the Treasury, CFIUS & the Protection of the National Security in the Dubai Ports World Bid for Port Operations (Feb. 24, 2006), available at <http://www.treas.gov/press/releases/js4071.htm> (describing CFIUS’s approval of the acquisition of a British company managing terminals in U.S. ports by Dubai Ports World, “a state-owned company located in the United Arab Emirates”).

5. See Foreign Investment and National Security Act of 2007 (FINSA), Pub. L. No. 110-49, 121 Stat. 246 (2007); see also Regulations Pertaining to Mergers, Acquisitions, & Takeovers by Foreign Persons, Proposed Rule, Notice of Inquiry and Public Meeting, 73 Fed. Reg. 21,861 (proposed Apr. 23, 2008) [hereinafter Regulations Pertaining to Mergers] (to be codified at 31 C.F.R. pt. 800); Matthew Swibel & Brian Wingfield, *Who Should Own America?* FORBES.COM, Mar. 8, 2007, http://www.forbes.com/2007/03/07/cfius-congress-dubai-biz-cx_bw_0308cfius.html (indicating that FINSA passed the House in March with a unanimous vote).

6. See *Private Equity Buyout Volume Sets Record*, L.A. TIMES, July 26, 2006, at C4.

7. William E. Fruhan Jr., *The Role of Private Equity Firms in Merger & Acquisition Transactions*, Harvard Business School Note 206-101, at 1 (rev. Oct. 16, 2006); see *Private Equity Buyout Volume Sets Record*, *supra* note 6, at C4.

contractors attractive acquisition targets for PE funds to the extent they provide predictable and steady cash flow. Despite new challenges in PE raised by the tightening of U.S. credit markets over the last year, PE has become an important vehicle for domestic and foreign investment in recent years.⁸ Nevertheless, PE garners criticism because unlike publicly traded companies with rigorous disclosure requirements, PE has little transparency, is largely unregulated, and is structured to take advantage of preferential tax rates.⁹

CFIUS has encouraged foreign entities acquiring government contractors directly to submit to “voluntary” CFIUS review where acquisitions could increase foreign access to proprietary data or technology or foreign control over domestic infrastructure. This Note explores whether there is comparable pressure on PE funds acquiring government contractors to submit to CFIUS review and argues that PE acquisitions of government contractors should be reviewable by CFIUS. As a matter of national security policy, it is not clear that PE structures themselves (primarily limited partnership agreements) insulate sensitive data, technology, or corporate control from foreign investors or foreign management. As a matter of business policy, disparate treatment of foreign entities interested in direct ownership and those working through PE gives PE a significant advantage. The “gauntlet” of CFIUS review has the potential to reward PE by bogging down direct investment.¹⁰ Policymakers should draft a more consistent CFIUS policy that responds to these national security, business, and broader fairness concerns raised by PE.

This Note argues that in order to strike the right balance between national security and open markets, policymakers should directly address the question of foreign investment through PE. Neither the recent statutory amendment nor the proposed regulations released in April 2008 confront this issue. Section II of this Note provides background on CFIUS, outlining the governing law, amended procedures, and major criticisms. Section III of this Note provides background on PE, describing the PE market, how PE works, and why government contractors are attractive to fund managers. Finally, Section IV addresses the difficult and uncertain application of the CFIUS statutes and regulations to PE and the consequences of this uncertainty. This section further proposes that lawmakers and policymakers impose pressure on PE to submit to CFIUS review, comparable to that imposed on other foreign acquirers, by amending the statute and promulgating new regulations that expressly subject PE-engineered acquisitions to CFIUS review.

8. See Don Jeffrey & Phil Milford, *Clear Channel, Bain, Lee Sue Banks over Buyout Plan (Update3)*, BLOOMBERG.COM, Mar. 26, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=arXY0eUGZmRI> (noting a recent surge of cases against lenders attempting to back out of deals during the current economic slowdown).

9. See generally *The Business of Making Money*, ECONOMIST, July 7, 2007, at 68; *The Trouble with Private Equity*, ECONOMIST, July 7, 2007, at 11; *The Uneasy Crown*, ECONOMIST, Feb. 10, 2007, at 74. But see JOSHUA LERNER ET AL., VENTURE CAPITAL & PRIVATE EQUITY: A CASEBOOK 483 (3d ed. 2005) (describing government-created PE firm In-Q-Tel).

10. Ronald D. Lee, *The Dog Doesn't Bark: CFIUS, the Guard Dog with Teeth*, M & A LAWYER 5, 10 (Feb. 2005), available at [http://www.arnoldporter.com/resources/documents/Article-National_Security_Guard_Dog\(2-05\).pdf](http://www.arnoldporter.com/resources/documents/Article-National_Security_Guard_Dog(2-05).pdf).

II. CFIUS BACKGROUND

CFIUS is the primary body charged with screening corporate acquisitions implicating national security. After outlining relevant statutes, regulations, and executive orders, this section considers the voluntary and flexible aspects of the review process, which arguably have helped the Committee strike the right balance between national security and open markets. This section concludes by considering complaints on both sides and the subsequent enactment of the FINSA amendment.

A. Governing Statutes, Executive Orders, and Regulations

The web of statutes, executive orders, and regulations that govern CFIUS begins with the “Exon-Florio Provision,” or section 721, of the Defense Production Act of 1950.¹¹ Exon-Florio was amended on July 26, 2007, when President Bush signed the Foreign Investment and National Security Act of 2007 into law.¹²

Exon-Florio, as amended, authorizes the President, “acting through the Committee,” (1) to *review* and *consider* “covered transactions” that “could result in foreign control of any person engaged in interstate commerce in the United States”¹³ and (2) to *suspend* or *prohibit* “any covered transaction that threatens to impair the national security of the United States.”¹⁴ The intent has not been to discourage foreign direct investment “but to provide a mechanism to review and . . . restrict FDI that threatens the national security.”¹⁵

Initially, the basic organization and procedures for CFIUS were largely provided by Executive Order No. 12,661, amending Executive Order No. 11,858, but FINSA now incorporates these materials directly into the statute.¹⁶ Pursuant to Exon-Florio as amended by FINSA, CFIUS is authorized to “conduct an investigation of the effects of a covered transaction on the national

11. Defense Production Act of 1950, ch. 932, sec. 721, § 2170, 102 Stat. 1425 (codified as amended at 50 U.S.C. app. 2170) (prior to 2007 amendment); Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 31 C.F.R. § 800 app. A (2007); Dep’t of the Treasury, Comm. on Foreign Investments in the United States (CFIUS), <http://www.ustreas.gov/offices/international-affairs/exon-florio> (last visited Jan. 26, 2007); Lewis, *supra* note 1, at 463.

12. FINSA, *supra* note 5; Regulations Pertaining to Mergers, *supra* note 5, at 21,862 (providing a summary of FINSA and noting that language from S. 1610, 110th Cong. (2007), was incorporated into H.R. 556, 110th Cong. (2007), and enacted as FINSA); *see generally* S. Rep. No. 110-80 (providing legislative history on FINSA).

13. 50 U.S.C. app. § 2170(a)(3), (b).

14. *Id.* app. § 2170(d)(1); *see* Dep’t of the Treasury, CFIUS, *supra* note 11.

15. Dep’t of the Treasury, CFIUS, *supra* note 11.

16. FINSA, *supra* note 5 (delegating under § 2170(a), (k)); *see* Exec. Order No. 12,661, 54 Fed. Reg. 779, 780-81 (Dec. 27, 1988) (delegating authority to CFIUS to receive notice and conduct investigations under Exon-Florio); *see also* Exec. Order No. 13,286, 68 Fed. Reg. 10,619, 10,629 (Feb. 28, 2003) (revising CFIUS membership); Exec. Order No. 12,860, 58 Fed. Reg. 47,201, 47,201 (Sept. 3, 1993) (revising CFIUS membership); Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 7, 1975) (establishing CFIUS mainly to monitor and evaluate the impact of foreign investment in the United States).

security of the United States, and take any necessary actions in connection with the transaction . . .”¹⁷ The FINSA amendment defines a “covered transaction” as “any merger, acquisition, or takeover . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States.”¹⁸ In general, CFIUS members are listed directly in the statute following FINSA, and the Department of the Treasury remains the lead agency, which is tasked with reassigning a lead agency on a case-by-case basis.¹⁹

The CFIUS regulations implementing pre-FINSA Exon-Florio were promulgated by the Department of the Treasury in 1991.²⁰ These regulations provide further (1) definitions and coverage (Subparts B and C) and (2) notice, review, and investigation procedures (Subparts D and E).²¹

The FINSA amendment became effective October 24, 2007. Though not a complete overhaul of CFIUS, it reorganized Exon-Florio, providing more detail in the statute itself and making certain changes to tweak the outcome of CFIUS’s balancing process.²² Among other changes, FINSA tightens congressional oversight, clarifies jurisdiction in transactions involving control by foreign governments, and adds new factors for CFIUS consideration.²³

The Treasury Department issued proposed regulations in April 2008, pursuant to a requirement set forth in FINSA.²⁴ The proposed regulations “retain many of the basic features of the exiting regulations.”²⁵ Final regulations will follow a forty-five-day comment period.²⁶

17. 50 U.S.C. app. § 2170(b)(2)(A); see Exec. Order No. 12,661, 54 Fed. Reg. 779, 780 (Dec. 27, 1988) (describing the pre-FINSA investigation and reporting procedures).

18. See FINSA, *supra* note 5 (codified at 50 U.S.C. app. § 2170(a)(3)).

19. See *id.* (codified at 50 U.S.C. app. § 2170(k)) (the Secretary of the Treasury, the Secretary of Homeland Security, the Secretary of Defense, the Secretary of Commerce, the Secretary of State, the attorney general, the Secretary of Energy, plus two nonvoting *ex officio* members—the Secretary of Labor and the director of National Intelligence—plus the “heads of any other executive department, agency or office as the President determines appropriate, generally or on a case by case basis”); Regulations Pertaining to Mergers, *supra* note 5, at 21,862; Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 7, 1975), as amended by Exec. Order No. 13,456, 73 Fed. Reg. 4677 (Jan. 25, 2008) (designating additional members (the U.S. Trade Representative, director of the Office of Science and Technology Policy, and the “heads of any other executive department, agency or office as the President determines appropriate, on a case-by-case basis”) and observers); cf. Exec. Order No. 13,286, 68 Fed. Reg. 10,619, 10,629 (Feb. 28, 2003).

20. Regulations Pertaining to Mergers, Acquisitions, & Takeovers by Foreign Persons, 31 C.F.R. § 800 (2007); Regulations Pertaining to Mergers, Acquisitions, & Takeovers by Foreign Persons, 56 Fed. Reg. 58,774 (Nov. 21, 1991) (codified at 31 C.F.R. § 800).

21. See Regulations Pertaining to Mergers, Acquisitions, & Takeovers by Foreign Persons, 31 C.F.R. § 800 (2007) (pre-FINSA regulations).

22. See Regulations Pertaining to Mergers, *supra* note 5, at 21,862–63 (summarizing FINSA).

23. *Id.* at 21,862; 50 U.S.C. app. § 2170(a), (b)(3), (f).

24. Regulations Pertaining to Mergers, *supra* note 5, at 21,861–62; 50 U.S.C. app. § 2170(b)(2)(E).

25. Regulations Pertaining to Mergers, *supra* note 5, at 21,863.

26. *Id.* at 21,861.

B. *A Voluntary Process*

In general, foreign parties contemplating an acquisition of a U.S. company²⁷ are not required to submit notice of the transaction to CFIUS unless affiliated with a foreign government.²⁸ However, failure to obtain CFIUS approval provides no guarantee against future divestment “of a concluded transaction that could threaten U.S. security interests.”²⁹ While technically voluntary,³⁰ foreign clients contemplating corporate acquisitions related to “national security” are often advised to obtain this limited safe-harbor guarantee.³¹

The U.S. Government Accountability Office (GAO) has reported problems with this voluntary process and the Committee’s limited monitoring presence. The GAO pointed to companies opting out of CFIUS review— consummating acquisitions without notice, without repercussions, and without further incentive to file.³² Furthermore, CFIUS member agencies have not had a strong monitoring presence.³³ While CFIUS review provides important assurances and is often required for closing, there is concern that review is not automatic and may allow certain transactions implicating national security to escape scrutiny. Absent public pressure, incentives to voluntarily file notice may be insufficient where parties suppose they may go undetected or otherwise believe that the transaction costs of submitting to CFIUS review outweigh the possible benefits.

27. *Id.* at 21,864, 21,872 (noting the proposed use of a new term of art, a “U.S. business” in § 800.227).

28. See FINSA, *supra* note 5 (codified at 50 U.S.C. app. § 2170(a) (defining a “foreign government-controlled transaction”); National Defense Authorization Act for Fiscal Year 1993, Pub. L. No. 102-484, § 837(a), 106 Stat. 2315, 2463 (1993) (formerly codified at 50 U.S.C. app. § 2170(b)) (triggering mandatory CFIUS review and investigation where the investor or acquirer is “controlled by or acting on behalf of a foreign government”); Larson & Marchick, *supra* note 1, at 11.

29. Harry L. Clark & Sanchitha Jayaram, *Intensified International Trade & Security Policies Can Present Challenges for Corporate Transactions*, 38 CORNELL INT’L L.J. 391, 394 (2005). But see Jessica Holzer, *National Security Chill on Takeovers*, FORBES.COM (Dec. 22, 2006), http://www.forbes.com/business/2006/12/21/cfius-outlook-washington-biz-wash-cx_jh_1222cfius.html (noting recent insertion of evergreen provisions in CFIUS agreements).

30. 31 C.F.R. § 800.401(a) (pre-FINSA regulations).

31. See, e.g., Regulations Pertaining to Mergers, *supra* note 5, at 21,862–63 (noting that CFIUS may reopen a submitted transaction where parties submit false or misleading information, where parties fail to submit material information, where a party intentionally and materially breaches negotiated mitigation agreements, or where there are no other remedies available); Skadden, Arps, CFIUS Practice Overview, <http://www.skadden.com/Index.cfm?contentID=47&practiceID=101&focusID=1> (last visited Jan. 14, 2008). But see David Marchick et al., National Security & Export Control (Jan. 9, 2007) (Covington & Burling LLP PowerPoint presentation), <http://acc.com/php/chapters/filespace/israel/ACC109Covington.ppt> (last visited May 8, 2008) (noting that many transactions fail to submit notice).

32. See U.S. GEN. ACCOUNTING OFFICE, DEFENSE TRADE: IDENTIFYING FOREIGN ACQUISITIONS AFFECTING NATIONAL SECURITY CAN BE IMPROVED 9–13 (2000) [hereinafter GAO, IDENTIFYING FOREIGN ACQUISITIONS] (companies have little incentive to attract attention, seeking safe harbor, once transactions are consummated).

33. See *id.* at 9, 13. But see 50 U.S.C. app. § 2170(b)(1)(D) (2006) (attempting to strengthen the Committee’s monitoring presence).

C. A Flexible Approach and the FINSA Response

Prior to the FINSA amendment, the formal procedures outlined in Exon-Florio and the CFIUS regulations provided a strict schedule, but beyond these procedures the Committee took a flexible approach to the process not reflected in the statute.³⁴ The Committee attempted to encourage full disclosure by adopting a flexible approach to help strike the right balance.³⁵ With FINSA, Congress codified elements of the review process developed by the Committee under this flexible approach but also increased congressional oversight³⁶ over CFIUS decisions and introduced minor substantive changes with some potential to tweak CFIUS decisions (so that CFIUS might not repeat the Dubai Ports World incident). The following discussion sketches the basic CFIUS process, the flexible approach CFIUS adopted pre-FINSA,³⁷ and the FINSA response to this approach.

The basic CFIUS process, for the most part unchanged³⁸ by FINSA, involves notice, a thirty-day “review” period, and, as needed, a forty-five-day “investigation” period. Initially, parties contemplating a transaction implicating “national security” may submit notice to CFIUS.³⁹ Or, in theory, any member agency could initiate review of a pending or completed transaction.⁴⁰ Next, CFIUS commences a thirty-day review period.⁴¹ In this stage, the Committee members may unanimously approve a transaction, concluding the process and clearing the parties to proceed with a guarantee that the President cannot use his Exon-Florio authority to suspend or prohibit the transaction.⁴² If CFIUS fails to unanimously approve the transaction, it may initiate an investigation period where “an extended review” is necessary.⁴³ CFIUS then issues

34. See Larson & Marchick, *supra* note 1, at 10.

35. See *The CFIUS Process*, *supra* note 1, at 22 (statement of Robert M. Kimmitt, Deputy Secretary, Department of the Treasury).

36. Regulations Pertaining to Mergers, *supra* note 5, at 21,862–63.

37. Regulations implementing FINSA were released on April 23, 2008, and no decisions under FINSA are publicly available.

38. Regulations Pertaining to Mergers, *supra* note 5, at 21,863. *But see id.* at 21,878 (requiring investigations in certain cases not required under the pre-FINSA statute or regulations (§ 800.503(b)).

39. See 50 U.S.C. app. § 2170(b)(1)(C); 31 C.F.R. § 800.401(a); Regulations Pertaining to Mergers, *supra* note 5, at 21,874; *see also* 31 C.F.R. § 800.402.

40. See 50 U.S.C. app. § 2170(b)(1)(D); 31 C.F.R. § 800.401(b); Regulations Pertaining to Mergers, *supra* note 5, at 21,874. *But see* GAO, IDENTIFYING FOREIGN ACQUISITIONS, *supra* note 32, at 9 (“Although the Committee’s member agencies have informed Treasury officials of acquisitions, agencies have never initiated the process that would require companies involved in an acquisition to provide information to the Committee [per] the regulations. Instead, Treasury officials generally encourage agencies to bring foreign acquisitions to their attention informally so that officials may . . . encourage [the companies involved] to report the acquisition voluntarily.”).

41. See 50 U.S.C. app. § 2170(b)(1) (national security review); 31 C.F.R. §§ 800.404, 800.402(b) (pre-FINSA regulations); Regulations Pertaining to Mergers, *supra* note 5, at 21,878.

42. See 31 C.F.R. § 800.403(d) (pre-FINSA regulations); Regulations Pertaining to Mergers, *supra* note 5, at 21,878–79. *But see* Clark & Jayaram, *supra* note 29, at 395.

43. See 50 U.S.C. app. § 2170(b)(2) (national security investigation); *The CFIUS Process*, *supra* note 1, at 8 (statement of Robert M. Kimmitt); Regulations Pertaining to Mergers, *supra* note 5, at 21,878. *But see* 50 U.S.C. app. § 2170(b)(2)(D) (the FINSA amendment allows the Secretary

a “recommendation” to the President at the end of this investigation stage indicating either unanimous approval or members’ reservations.⁴⁴ The President then has fifteen days to suspend or prohibit the transaction.⁴⁵

The pre-FINSA statute simply permitted CFIUS to approve a transaction or recommend against approval during this period.⁴⁶ However, pre-FINSA CFIUS frequently advised applicants to withdraw applications⁴⁷ when approval appeared unlikely under any circumstances or to withdraw and reapply when more time was needed to negotiate mitigation arrangements.⁴⁸ This liberal withdrawal policy and other aspects of the process are characteristic of the Committee’s flexible pre-FINSA approach. Pre-FINSA CFIUS encouraged prefling consultation and open communication with Committee members, saving parties expense and embarrassment when a deal could not proceed.⁴⁹ Furthermore, Committee members communicated with applicants directly throughout the process, often conditioning CFIUS approval on negotiated risk mitigation arrangements.⁵⁰ The Committee “interpret[ed] its authority...as providing it with ‘the authority to negotiate measures to mitigate national security concerns when other regulatory regimes do not apply.’”⁵¹ Common mitigation arrangements have included “network security agreements,”⁵² required divestment of subsidiary government contractors,⁵³ national security agreements with member agencies,⁵⁴ or guarantees of no

of the Treasury and the head of the “lead agency” jointly to exempt certain transactions from the investigation process).

44. See *The CFIUS Process*, *supra* note 1, at 8 (statement of Robert M. Kimmitt).

45. See *id.*; 50 U.S.C. app. § 2170(d).

46. Dep’t of the Treasury, CFIUS, *supra* note 11.

47. See 31 C.F.R. § 800.505 (pre-FINSA regulations, “Withdrawal of notice”); U.S. Gov’t ACCOUNTABILITY OFFICE, DEFENSE TRADE: ENHANCEMENTS TO THE IMPLEMENTATION OF EXON-FLORIO COULD STRENGTHEN THE LAW’S EFFECTIVENESS 15–16, 34 (2005) [hereinafter GAO, ENHANCEMENTS]; U.S. GEN. ACCOUNTING OFFICE, DEFENSE TRADE: MITIGATING NATIONAL SECURITY CONCERNS UNDER EXON-FLORIO COULD BE IMPROVED 8–9 (2002) [hereinafter GAO, MITIGATING NAT’L SECURITY CONCERNS].

48. See *The CFIUS Process*, *supra* note 1, at 66 (statement of David M. Marchick, Partner, Covington & Burling LLP); Larson & Marchick, *supra* note 1, at 10.

49. *The CFIUS Process*, *supra* note 1, at 13 (statement of Eric S. Edelman, Under Secretary, DoD), 26 (statement of Robert M. Kimmitt), 85 (written statement of Robert M. Kimmitt); see 31 C.F.R. § 800.701 (2006); Regulations Pertaining to Mergers, *supra* note 5, at 21, 879 (“Obligation of parties to provide information”); GAO, ENHANCEMENTS, *supra* note 47, at 41; see generally 31 C.F.R. § 800 app. A.

50. See *The CFIUS Process*, *supra* note 1, at 12–13 (statement of Eric Edelman) (referring to “risk mitigation measures” including negotiations with the parties directly and measures available under NISPO); see also GAO, MITIGATING NAT’L SECURITY CONCERNS, *supra* note 47, at 9–10 (discussing the enforceability of risk mitigation agreements); Lee, *supra* note 10, at 9 (conditioning CFIUS approval on a good-faith divestment of a subsidiary holding government contracts for optics technology).

51. Lee, *supra* note 10, at 9 (citing GAO, MITIGATING NAT’L SECURITY CONCERNS, *supra* note 47, at 4).

52. See Lewis, *supra* note 1, at 467, 470–71.

53. See Lee, *supra* note 10, at 9.

54. Larson & Marchick, *supra* note 1, at 11–12.

more than a passive role.⁵⁵ Because the review process required unanimous approval to avoid an investigation, each member had leverage to independently impose conditions.⁵⁶ The Committee crafted these flexible mechanisms ostensibly to encourage corporate disclosure and to strike what it considered to be the right balance.

FINSA expressly authorizes CFIUS to continue on this path, using a fairly flexible, ad hoc approach.⁵⁷ However, FINSA also attempts to limit the blank check previously handed to CFIUS by increasing congressional oversight over CFIUS decisions and ostensibly requiring investigations in more situations.⁵⁸ FINSA codifies the Committee's liberal withdrawal and reapplication policy, its use of prefiling consultation, and its use of risk mitigation arrangements.⁵⁹ FINSA also lends more structure to the process and centralizes mitigation negotiations by appointing a "lead agency."⁶⁰ And quite significantly, FINSA increases congressional oversight.⁶¹ Thus, the FINSA amendment to Exon-Florio blesses and strengthens the Committee's flexible approach in some respects and corrects the Committee's approach in others.⁶² FINSA does not overhaul the CFIUS process but instead represents an attempt to codify this approach, strengthen congressional oversight, and slightly tweak the way CFIUS strikes the balance between national security and open markets.

D. *Complaints from Both Sides*

The FINSA amendment responds to complaints from both sides and attempts to provide some instruction to CFIUS about how to strike the proper balance. From the national security side of the debate, many of the complaints about the pre-FINSA process expressed frustration over the degree of discretion, secrecy, and apparent leniency surrounding the review process.⁶³ From the business standpoint, many of the complaints expressed frustration with the CFIUS requirements, which may impose high transaction costs on

55. See JAMES K. JACKSON, CONG. RESEARCH SERV., REP. NO. RL22197, THE EXON-FLORIO NATIONAL SECURITY TEST FOR FOREIGN INVESTMENT 5 (Feb. 23, 2006) (referring to Global Crossing in 2003).

56. See GAO, ENHANCEMENTS, *supra* note 47, at 32–33; cf. NISPOM, *supra* note 2, at 2-3-2 (describing methods used by DoD to mitigate the risk of foreign ownership or control, including board resolutions, voting trust agreements, proxy agreements, Special Security Agreements (SSAs), and Security Control Agreements (SCAs)); Lee, *supra* note 10, at 9.

57. Regulations Pertaining to Mergers, *supra* note 5, at 21,863.

58. *Id.* at 21,862 (noting that investigations are required in four situations: where mitigation arrangements are not resolved in the thirty-day review, where the acquirer is controlled by a foreign government, where the transaction implicates critical infrastructure, or where the lead agency recommends investigation).

59. *Id.*; 50 U.S.C. app. § 2170(b)(l).

60. 50 U.S.C. app. § 2170(k)(5); see Regulations Pertaining to Mergers, *supra* note 5, at 21,880 (noting that FINSA gives CFIUS new recourse for breaches of mitigation agreements including possible imposition of civil penalties under proposed § 800.801, including liquidated damages, appealable to CFIUS).

61. 50 U.S.C. app. § 2170(b)(3), (g).

62. Regulations Pertaining to Mergers, *supra* note 5, at 21,862.

63. See, generally, *The CFIUS Process*, *supra* note 1.

businesses. FINSA responds to some of these complaints, but ultimately it is unlikely that FINSA represents much substantive change in the CFIUS process.

1. National Security Complaints

There are at least three complaints from proponents of more stringent CFIUS review. First, the flexible process for CFIUS review permits significant discretion and ad hoc maneuvering by Committee members. While some consider this a virtue,⁶⁴ CFIUS's approval of the Dubai Ports World deal indicated to others that the Committee was misusing this flexibility, tipping the delicate balance in favor of open markets without sufficient consideration of national security.⁶⁵ FINSA blesses the Committee's flexible approach in certain procedural ways, but ostensibly attempts to avoid the Dubai Ports World outcome by suggesting that the Committee consider additional factors in its national security review and investigations.⁶⁶

Second, the CFIUS process is confidential, and public access to CFIUS decisions is limited. CFIUS review is exempt from the Freedom of Information Act due to the exchange of proprietary, classified, and inside information.⁶⁷ This makes it difficult for the public to assess whether CFIUS is striking the right balance.⁶⁸ FINSA does not address this complaint.

A third related problem concerns congressional oversight of CFIUS. Oversight has been limited by the Committee's reluctance to report to Congress and by statutory reporting requirements rendered less effective by the Committee's liberal withdrawal policy.⁶⁹ The Committee has attributed its reluctance to concerns about national security, insider trading, and misuse of proprietary information.⁷⁰ Pre-FINSA Exon-Florio required reports to Congress only if an investigation was triggered and the Committee's liberal withdrawal policy defeated the reporting requirement by resolving most applications during the review stage.⁷¹ FINSA closes this loophole by requiring more reports to Congress at the completion of both the review and investigation stages⁷² and clarifies confidentiality requirements for information disclosed to members of Congress and their staffs.⁷³

64. See, e.g., David A. Menard, *The Flexibility of Exon-Florio Amendment & the Expansion of Telecommunications into the Global Economy*, 31 PUB. CONT. L.J. 313, 336 (2002).

65. See, generally, *The CFIUS Process*, *supra* note 1.

66. See 50 U.S.C. app. § 2170(f) (permissive language is used).

67. See *The CFIUS Process*, *supra* note 1, at 25 (statement of Robert M. Kimmitt).

68. See 31 C.F.R. § 800 app. A (2007).

69. GAO, ENHANCEMENTS, *supra* note 47, at 4.

70. FINSA, *supra* note 5 (codified at 50 U.S.C. § 2170(g)) (requiring members of Congress to give assurances of confidentiality).

71. GAO, ENHANCEMENTS, *supra* note 47, at 41.

72. 50 U.S.C. app. § 2170(b)(3) (certification to Congress); Regulations Pertaining to Mergers, *supra* note 5, at 21,863.

73. 50 U.S.C. app. § 2170(g).

2. Business Complaints

There are at least three complaints from businesses that see CFIUS as yet another regulatory hurdle. First, the lack of transparency makes the CFIUS review process mysterious for parties considering international transactions. There are few guideposts and no binding precedent because national security concerns evolve over time.⁷⁴ Access to information about CFIUS decisions requires hiring attorneys with institutional knowledge of the Committee. The Committee considers transactions on a case-by-case basis in a way that can frustrate corporate strategists. FINSA does not address this complaint.

Second, the CFIUS process imposes high transaction costs on businesses. It is a time-consuming process that must begin early in negotiations for a proposed transaction. Delays not only add to the monetary cost of deals but may even make certain deals cost prohibitive—discouraging acquisitions involving foreign parties. While CFIUS review may be brief, there are no guarantees. Despite the tight schedule, the leverage the Committee members wield can lead to significant delay. Harry L. Clark and Sanchitha Jayaram explain that

[t]he process of obtaining clearance can complicate and delay transactions enormously, even when clearance is ultimately provided. The clearance process is designed to last no more than 80 days. However, the parties are often forced to withdraw and refile their transaction notifications, thereby restarting the process, under threat that the transaction will otherwise be blocked.⁷⁵

This delay may also reduce the valuation of the company being acquired: “If you lengthen the time that even noncontroversial investments take, then you are putting foreign investors at a disadvantage and potentially lowering the valuations of U.S. companies.”⁷⁶ Except for some attempt to make filing itself more “efficient,” FINSA and the proposed regulations do not address this complaint.⁷⁷

Third, a related complaint is that companies are often hamstrung to accept whatever conditions Committee members require—often perceived as unreasonable—in order to close a deal. The Committee has transformed its power to block a transaction into the power to condition approval upon actions “that are deemed to obviate perceived security concerns.”⁷⁸ FINSA

74. In spite of requests for guidance on the term “national security,” CFIUS refused to adopt proposals in the comments requesting binding advisory opinions or a digest of CFIUS reviews. See 31 C.F.R. § 800 app. A at 1088 (2007). *But see* Regulations Pertaining to Mergers, *supra* note 5, at 21,863 (noting that CFIUS is preparing guidelines on the type of information useful at the filing stage).

75. Clark & Jayaram, *supra* note 29, at 391, 396.

76. Tim Reason, *America for Sale: Foreign Firms Are Buying U.S. Companies at the Fastest Clip in Five Years, Creating Concerns on Capitol Hill*, CFO.COM, Feb. 2, 2006, http://www.cfo.com/article.cfm/5435380/c_8435337 (quoting David M. Marchick).

77. Regulations Pertaining to Mergers, *supra* note 5, at 21,863.

78. Clark & Jayaram, *supra* note 29, at 396. While some conditions may be reasonable, others may add substantial costs to transactions—not only the costs of setting up U.S. subsidiaries in some cases but perhaps also major strategic costs, such as requiring divestment over a certain period.

attempts to respond to this complaint by centralizing the mitigation agreement process, but the substantive impact of appointing a “lead agency” is unclear. At the same time, FINSA may strengthen the power CFIUS wields when mitigation agreements are breached.

3. A Definitional Complaint

In addition to these complaints, both sides agree that the failure to define “national security”⁷⁹—in terms of either an exhaustive list of factors that the Committee may consider or a list of included/excluded industries—proves incredibly frustrating. The term “national security” was not defined and continues to be a matter of presidential discretion.⁸⁰ The statute⁸¹ and the pre-FINSA regulations provide some guidance on the Committee’s general views as to when filing might be considered appropriate, but the factors listed do not have the legal effect of exemptions or lists.⁸²

The decision not to define “national security” has the benefit of letting the term evolve as national needs change, but it frustrates parties to transactions that are only marginally related to national security, adding ostensibly unnecessary costs to those marginal transactions.⁸³ The frustration, of course, is the unpredictability of whether the Committee will define “national security” broadly or narrowly.

Following September 11, 2001, the Bush administration adopted a broad interpretation of national security⁸⁴—for instance, opening up the possibility that CFIUS approval was required for acquisitions of a semiconductor lithography company,⁸⁵ telecommunications and Internet service providers,⁸⁶ domestic infrastructure, and other industries not directly tied to the defense supply chain. Yet the GAO has expressed concern that Committee members adopt narrow, agency-specific definitions of national security. This is problematic when one agency does not refer an unreported transaction to the

79. See 31 C.F.R. § 800 app. A at 1090 (2007) (rejecting comments requesting a bright-line test for control, “which would make it relatively easy to structure transactions to circumvent the statute,” instead preferring a functional test for control, “in terms of the ability of the acquirer to make certain important decisions about the acquired company, such as whether to dissolve the entity, or to relocate or close production or research and development facilities”); Regulations Pertaining to Mergers, *supra* note 5, at 21,863–64 (explaining that “control” is defined “in functional terms as the ability to exercise certain powers over important matters affecting a business”).

80. 31 C.F.R. § 800 app. A (2007) (citing legislative history including H.R. REP. NO. 100-576, at 925–28 (1988), and the U.S. Constitution as authority for the proposition that national security may be interpreted broadly and ultimately is a matter of presidential discretion).

81. See 50 U.S.C. app. § 2170(f) (“Factors to be considered”).

82. See 31 C.F.R. § 800 app. A (2007).

83. See, e.g., Clark & Jayaram, *supra* note 29, at 394–95 (“In the 1990s, parties typically only bothered to seek a clearance from the CFIUS if the transaction directly implicated military activity, such as the acquisition of a defense contractor.”); see also Larson & Marchick, *supra* note 1, at 5, 11 (describing the effects of the Dubai Ports World transaction).

84. See *The CFIUS Process*, *supra* note 1, at 66 (statement of David Marchick); see Clark & Jayaram, *supra* note 29, at 395.

85. See Clark & Jayaram, *supra* note 29, at 395.

86. See *id.*

whole Committee, assuming that only its narrow concept of national security applies.⁸⁷ Furthermore, there is a sense that the Committee generally is taking an overly narrow view of national security, going so far as to argue that open markets themselves actually contribute to (rather than impair) national security.⁸⁸

Thus, while CFIUS serves an important role in striking the right balance between national security and open markets, there has been significant debate as to whether the Committee strikes the right balance. This debate has spurred Congress to action. The Committee walks a fine line—trying to balance its need for corporate cooperation and disclosure with its need to limit foreign access to data and technology and control of infrastructure. FINSA alleviates some but not all of these concerns by increasing congressional oversight, authorizing mitigation arrangements, increasing monitoring of withdrawn applications, and expanding the list of “national security” factors CFIUS may consider.⁸⁹ However, it leaves the PE question open.

III. BACKGROUND ON PRIVATE EQUITY

PE funds—individually and in consortium (club deals)—have engineered several major corporate acquisitions in the last few years at prices previously unheard of in PE. In 2006, a leading PE expert noted that “[h]istorically, almost all merger and acquisition activity has involved one operating firm acquiring another operating firm. In recent years, however, financial sponsors have been growing in importance in acquisition activity.”⁹⁰ The years 2006 and 2007 were record-setting years in PE in terms of the deals negotiated (size and number) and of the money pouring into PE (capital commitments).⁹¹

87. GAO, ENHANCEMENTS, *supra* note 47, at 39–41, 44–45 (suggesting that, ironically, the Committee justifies its resistance to a strict definition of national security by arguing that a flexible definition is necessary to preserve presidential discretion; and yet, the Committee’s reluctance to adopt a broad definition has actually prevented the President from exercising his discretion as very few transactions trigger the investigation process that is reportable to the President).

88. See U.S. GOV’T ACCOUNTABILITY OFFICE, DEFENSE TRADE: IMPLEMENTATION OF EXON-FLORIO 5 (2005). For example, certain members of the business community and certain Committee members have argued that open markets contribute to goodwill with foreign countries, strengthening alliances that in turn can be used to advance national security initiatives abroad. In the Dubai Ports World case, Committee members insisted that approving the deal would further national security by reinforcing the United States’ relationship with the United Arab Emirates, which in turn would advance other national security initiatives and broader national security policy. This is essentially an argument that open markets themselves contribute to national security. See *The CFIUS Process*, *supra* note 1, at 14 (statement of Eric S. Edelman) (referring to the Container Initiative); GAO, ENHANCEMENTS, *supra* note 47, at 28; Reason, *supra* note 76 (“Still, the U.S. business community seems less concerned with issues of national security than with keeping the door open wide to investment.”).

89. See FINSA, *supra* note 5.

90. Fruhan, *supra* note 7, at 1.

91. See Andrew Ross Sorkin & Terry Pristin, *Blackstone Acquiring Trust in Richest Buyout*, N.Y. TIMES, Nov. 20, 2006, at A21; see also Dan Lonkevich & Edward Klump, *KKR, Texas Pacific Will Acquire TXU for \$45 Billion (Update 9)*, BLOOMBERG.COM, Feb. 26, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a.9hamjj11wI> (“Buyout firms announced

Prominent deals announced in 2006 included leveraged buyouts (LBOs) of Aramark, a food services company, for \$8.3 billion (club deal);⁹² Freescale Semiconductor, a semiconductor designer and manufacturer, for \$17.6 billion (club deal);⁹³ Kinder Morgan, a gas pipeline company, for \$22 billion (club deal);⁹⁴ the radio division of Clear Channel, a media company, for \$26 billion (club deal);⁹⁵ and HCA, Inc., a for-profit hospital chain, for \$33 billion (club deal).⁹⁶ In early 2007, Blackstone's then record-setting \$36 billion bid for Equity Office Properties Trust, a real estate company,⁹⁷ was topped only weeks later by a club deal acquiring TXU, a Texas power company, for \$45 billion, still the largest U.S. LBO to date.⁹⁸ As the credit markets began to tighten in mid-2007, "private-equity deal making has ground to a virtual halt."⁹⁹ Lenders are less generous given the current state of the credit markets,

a record of more than \$700 billion in takeovers last year, and almost \$50 billion so far this year, according to data compiled by Bloomberg. Investors, seeking returns that exceed stocks and bonds, poured a \$432 billion into private-equity funds last year, also a new high, according to London-based Private Equity Intelligence Ltd."); Steve Rosenbush, *The Money Behind the Private Equity Boom*, BUSINESSWEEK.COM (Nov. 7, 2006), http://www.businessweek.com/investor/content/nov2006/pi20061107_031256.htm; Emily Thornton, *Gluttons at the Gate: Private Equity Firms Are Using Slick New Tricks to Gorge on Corporate Assets. A Story of Excess*, BUSINESSWEEK, Oct. 30, 2006, at 60–64 (as a percentage of the amount of capital invested in the overall stock market in 2006, the amount of capital invested in private equity funds in 2006 reached a historic high—0.8 to 0.9 percent of the overall capital investments in 2006, exceeding the previous high point in LBO activity, the "1987 peak," of about 0.6 percent).

92. See Press Release, Aramark, Aramark Announces Signing of Merger Agreement (Aug. 8, 2006), <http://www.aramark.com/PressReleaseDetailTemplate.aspx?PostingID=892&ChannelID=321>.

93. See Press Release, Freescale Semiconductor, Consortium of Private Equity Firm Completes Acquisition of Freescale Semiconductor (Dec. 1, 2006), <http://media.freescale.com/phoenix.zhtml?c=196520&p=irol-newsArticle&ID=937966&highlight>.

94. See Press Release, Kinder Morgan, Kinder Morgan, Inc. Enters into Agreement to Sell to Investor Group for \$107.50 per Share (Aug. 28, 2006), <http://phx.corporate-ir.net/phoenix.zhtml?c=93621&p=irol-newsArticle&ID=899575&highlight>.

95. See Press Release, Clear Channel Commc'ns, Clear Channel Communications, Inc. Enters into Merger Agreement with Private Equity Group Co-led by Bain Capital Partners, LLC and Thomas H. Lee Partners, L.P. (Nov. 16, 2006), <http://www.clearchannel.com/Corporate/PressRelease.aspx?PressReleaseID=1824>; see also *Clear Channel, Private Equity Firms Sue Banks*, CNNMONEY.COM (Mar. 26, 2008), http://money.cnn.com/2008/03/26/news/companies/clear_channel/index.htm?section=money_topstories (explaining that "banks that were gladly loaning money for ever bigger leveraged buyouts just a year ago are now concerned about whether the company can generate enough free cash flow to cover the interest payments in a miserly credit market"); Peter Lattman & Matthew Karnitschnig, *Banks Defend Clear Channel Funding Effort*, WALL ST. J., Apr. 1, 2008, at C12 (the bid for Clear Channel has since encountered major problems, now valued at \$19 to \$20 billion).

96. Sorkin & Pristin, *supra* note 91.

97. *Id.* (the Equity Office deal was considered by some to be further evidence of "how private equity firms continue to gobble up corporate America").

98. Lonkevich & Klump, *supra* note 91.

99. Peter Lattman, *Wall Street's Buyout Stars Keep Fleeing*, WALL ST. J., Apr. 4, 2008, at C1–C3 ("Until the credit markets clammed up last summer, buyout shops were a giant profit center for Wall Street. The banks generated hundreds of millions of dollars in fees advising on multibillion-dollar deals to acquire companies. Bigger profits were in the financing, as the banks took in billions underwriting loans and junk bonds to be sold to investors. Last year, J.P. Morgan earned roughly \$1.3 billion in fees from private-equity firms, according to data provider Dealogic. Today, a slew of busted deals have weakened those ties, in some cases leading to litigation. Banks have

exemplified by the troubled Clear Channel deal, which has prompted lawsuits against lenders in both New York and Texas state courts.¹⁰⁰ Nonetheless, as the money flooding the private equity market has increased, with some of the leading “brands”¹⁰¹ in private equity closing some of the largest funds on record,¹⁰² the number of funds has increased and PE has emerged as a key part of the global economy.

A. *An Explanation of PE and Applicable Regulations*

PE,¹⁰³ sometimes called “financial sponsors,” is a way for a set of investors¹⁰⁴—including wealthy individuals, family offices, institutional investors, and endowments—to pool cash¹⁰⁵ into “PE funds” that then invest in operating companies. Because the best-performing PE funds can achieve 20 to 30 percent returns,¹⁰⁶ investors expect PE to outperform the market.¹⁰⁷ PE funds are managed by principals who choose the operating companies in which the fund will invest. To align investors’ and principals’ interests, the principals derive their income as a percent of the return on the capital invested by the fund, a percentage known as the carried interest.¹⁰⁸

In general, cash from a fund is used to partially finance an acquisition of an undervalued operating company for the fund’s portfolio. Characterized by the

written down billions of dollars of leveraged loans from private-equity deals, seriously crimping their years of profits. Meanwhile, private-equity deal making has ground to a virtual halt, leaving the investment-banking units that cover private-equity firms overstaffed. Total investment-banking fees paid by buyout shops globally fell 77% in the first quarter from a year earlier, says Dealogic.”)

100. *Clear Channel, Private Equity Firms Sue Banks*, *supra* note 95; Lattman & Karnitschnig, *supra* note 95.

101. See LERNER ET AL., *supra* note 9, at 140.

102. See, e.g., Andrew Ross Sorkin (ed.), *Blackstone’s Big Real-Estate Fund*, N.Y. TIMES DEALBOOK, Apr. 2, 2008, <http://dealbook.blogs.nytimes.com/2008/04/02/blackstone-closes-109-billion-real-estate-fund/> (in 2008, Blackstone has already closed a \$10.9 billion real estate fund).

103. See Fruhan, *supra* note 7, at 1 (providing overview of the PE model).

104. See Rules Governing the Limited Offer & Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.501(a) (2007) (defining an “accredited investor”). But see Karyn McCormack, *An EFT Ventures into Private Equity*, BUSINESSWEEK.COM, Oct. 18, 2006, http://www.businessweek.com/investor/content/oct2006/pi20061019_065916.htm (noting that individual investors may want to pass on the new exchange-traded fund, The Powershares Listed Private Equity Portfolio).

105. Joshua Lerner, *A Note on Private Equity Partnership Agreements*, Harvard Business School Note 294-084, at 2 (rev. Mar. 4, 2001) (explaining that funds do not pool the cash at once; instead, they typically accept commitments of cash or sometimes non-interest-bearing notes drawn as the fund invests).

106. See Jon Birger, *Private Equity Myth: The Little Guy Loses*, CNNMONEY.COM, Mar. 23, 2007, http://money.cnn.com/2007/03/23/magazines/fortune/private_equity.fortune/index.htm; see also Peter Smith, *Investors Turn to Unlisted Options*, FIN. TIMES, Nov. 18, 2002 (suggesting an “illiquidity premium”).

107. Ellen Simon, *Shareholders Rebelling Against Buyouts*, BOSTON.COM, Nov. 17, 2006, http://www.boston.com/news/education/higher/articles/2006/11/17/shareholders_rebelling_against_buyouts/?rss_id=Boston.com+%2F+News.

108. See Daniel Covitz & Nellie Liang, *Recent Developments in the Private Equity Market & the Role of Preferred Returns*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. 7 (2002), available at <http://www.bis.org/publ/cgfs19board1.pdf>.

stage of the company in which the fund invests and the type of financing arranged, PE funds broadly include venture capital (VC) funds and LBO funds. In an LBO fund, the acquisition of an operating company, known thereafter as a “portfolio company,” is financed using some portion of the fund’s pooled cash (equity) plus additional borrowed money (debt). A typical LBO will involve 20 to 25 percent equity and 75 to 80 percent debt.¹⁰⁹ The use of debt may be controversial in some extreme cases of overleveraging, but, in general, leveraging an acquisition through the use of debt is standard practice.¹¹⁰

The term “private equity” refers to the fact that the acquired company becomes privately owned, not publicly traded. While a fund can acquire a private or public company, the key is finding an undervalued company with significant potential for growth, expansion, or improved efficiency within the fund’s time horizon. The fund’s goal is optimizing the portfolio company’s performance over the life of its investment, strategically exiting the investment, and then returning proceeds to investors. PE funds typically are organized as limited partnerships with fixed terms and are “designed to be ‘self-liquidating’: that is, to dissolve after ten or twelve years.”¹¹¹ During an average ten-year term, a fund will buy interests in several operating companies, add them to its portfolio, manage the portfolio companies, and eventually sell all of its interests in the portfolio companies to distribute sale proceeds to the fund’s investors.

The fund’s exit strategy is critical to its success. After a few years (three-to-five- or five-to-seven-year time horizons)¹¹² and some value added from the management expertise of the PE fund, PE funds recoup their initial investment and take returns when, for example, they take the company public through an IPO.¹¹³ An exit strategy for a PE fund is crucial because investors in a PE fund do not want illiquid securities; they want high, liquid returns.¹¹⁴

Unlike publicly traded securities, private securities¹¹⁵ are exempt from SEC registration under Regulation D.¹¹⁶ Publicly traded securities are highly

109. Fruhan, *supra* note 7, at 1.

110. See *The Role of Private Equity in the Public Marketplace: Hearing Before the Subcomm. on Telecommunications and the Internet of the H. Comm. on Energy and Commerce*, 110th Cong. (2008) [hereinafter *Role of Private Equity*] (statement of Carlito P. Caliboso, Chairman, PUC of Hawaii) (raising concern over the 82.5 percent debt to 17.5 percent equity capital structure for Carlyle-owned Hawaii Telecom, Inc.); Thornton, *supra* note 91, at 62 (noting that PE funds may pass to the newly acquired company a “higher debt burden brought about to finance payments to [PE fund] owners”).

111. LERNER ET AL., *supra* note 9, at 22.

112. See Fruhan, *supra* note 7, at 1; Anthony Bianco, *Private Equity at Its Most Private*, BUSINESSWEEK.COM, Nov. 6, 2006, http://www.businessweek.com/magazine/content/06_45/b4008008.htm.

113. See Thornton, *supra* note 91, at 63.

114. Rosenbush, *supra* note 91.

115. Private securities are securities issued to effect the transfer of interests in the acquisition by the PE fund.

116. See Rules Governing the Limited Offer & Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R. § 230.506 (2007) (commonly referred to as Regulation D); SEC. AND EXCHANGE COMM’N, REGULATION D OFFERINGS, <http://www.sec.gov/answers/regd.htm> (last visited May 6, 2008) (noting that Regulation D provides three exemptions “allowing some

regulated by the Securities and Exchange Commission (SEC) and must meet the registration requirements of section 5 of the Securities Act of 1933.¹¹⁷ Regulation D relates to transactions exempted from the registration requirements, thus governing private offerings of securities and creating a safe harbor for companies that qualify under at least one of the Regulation D exemptions.¹¹⁸ PE funds typically qualify for the Regulation D exemption under Rule 506.¹¹⁹ The two most significant requirements in Rule 506 are the “no general solicitation” requirement (restricting PE funds from soliciting and advertising) and the “accredited investor” requirement (requiring enhanced disclosure if there are any nonaccredited investors).¹²⁰ The second requirement—the accredited investor requirement—has the effect of restricting the PE investor class to very high net worth or to high-income individuals and major institutional investors.¹²¹ Although in theory this prevents lower-net-worth or lower-income individuals from taking advantage of the PE market, “an individual who does not meet the net worth or income levels needed to qualify as an accredited investor is unlikely to have the financial resources to invest enough money in a private equity fund to make his or her participation attractive to the Sponsor and the Principals.”¹²² PE funds also take steps to limit the total number of investors to avoid reporting requirements of the Investment Company Act of 1940,¹²³ which would require registration as an investment advisor.¹²⁴

Because PE is exempt from the reporting requirements imposed on public companies, PE portfolio companies (like many other private companies) often lack transparency. As explained in a 1995 study on “The Economics of the Private Equity Market” from the Federal Reserve, “[a] private equity security is exempt from registration with the Securities Exchange Commission by virtue of its being issued in transactions ‘not involving any public offering.’

smaller companies to offer and sell their securities without having to register the securities with the SEC”).

117. See 17 C.F.R. §§ 230.501–508.

118. JAMES M. SCHNELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE & OPERATIONS, Release 8, at 8-4 (2004).

119. See 17 C.F.R. § 230.506 (Rule 506); SCHNELL, *supra* note 118, at 8-4; SEC. AND EXCHANGE COMM’N, RULE 506 OF REGULATION D, <http://www.sec.gov/answers/rule506.htm> (last visited May 6, 2008).

120. See Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles, Accredited Investors in Certain Private Investment Vehicles, Proposed Rule, 72 Fed. Reg. 400, 405 (Jan. 10, 2007) (proposing changes to the definition of an “accredited natural person,” which may have implications for the definition of an “accredited investor”); *see also* Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles, Final Rule, 72 Fed. Reg. 44,756, 44,756 n.2 (Aug. 9, 2007) (deferring consideration of such definition); SEC. AND EXCHANGE COMM’N, RULE 506 OF REGULATION D, <http://www.sec.gov/answers/rule506.htm>.

121. See Timothy Spangler, *SEC Publishes Text of New Rules for Hedge Fund & Private Equity Fund Advisors*, at 2 (Jan. 2007), [http://www.kayescholar.com/web.nsf/0/D07AF1A6BB7161818525725D0058B5FF/\\$file/InvestFundsClientAlertJan07.pdf](http://www.kayescholar.com/web.nsf/0/D07AF1A6BB7161818525725D0058B5FF/$file/InvestFundsClientAlertJan07.pdf) (noting that accredited investors are deemed sophisticated enough to understand the risk of their investment and wealthy enough to absorb high losses).

122. SCHNELL, *supra* note 118, at 8-6 (§ 8.01[2](a)).

123. See Investment Company Act of 1940, codified at 15 U.S.C. §§ 80a-1 to -64 (2000).

124. Lerner, *supra* note 105, at 2.

Thus, information about private transactions is often limited, and analyzing developments in the market is difficult.¹²⁵

B. The Role PE Serves and Why Government Contractors Are Especially Attractive to PE Funds

PE serves an important role, providing an infusion of capital to companies when they have limited options for “external financing.”¹²⁶ Options may be limited by the nature of a company’s business, its stage of development, or its financial troubles.¹²⁷ Traditional external financing, such as bank loans, may be unavailable when a company’s liabilities exceed its assets, a common occurrence when an entrepreneur has “significant intangible assets” or “uncertain prospects” or when a “troubled” company faces restructuring.¹²⁸ A leading PE expert, Joshua Lerner of the Harvard Business School, notes that

private equity investors are looking for companies that have the potential to evolve in ways that create value. This evolution may take several forms. Early stage entrepreneurial ventures are likely to grow rapidly and respond swiftly to the changing competitive environment. Alternatively, the managers of buyout and build-up firms may create value by improving operations and acquiring other rivals. In each case, the firm’s ability to change dynamically is a key source of competitive advantage, but also a major problem to those who provide the financing.¹²⁹

Thus, PE can provide crucial capital when traditional financing is unavailable because of lenders’ lower tolerance for risk. The price PE charges for that capital infusion typically includes a majority or controlling interest in the portfolio company and enough director seats to control the board.

Many PE funds see government contractors as particularly attractive companies in which to invest. Government contractors are often predictable, reliable sources of income over time. That income is often critical to the way PE funds (especially LBO funds) finance their acquisitions of the companies in the first place. Most PE funds estimate that they will hold an investment for, on average, five years.¹³⁰ Locking up capital for five years is risky and expensive, so PE firms have generally looked to invest in companies that “generate[] lots of cash” and have used debt on the front end to “fund the payments of cash dividends to themselves and other equity holders.”¹³¹ Companies with strong

125. George W. Fenn et al., *The Economics of the Private Equity Market*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 1 (1995), available at http://www.federalreserve.gov/pubs/staff_studies/1990-99/ss168.pdf.

126. LERNER ET AL., *supra* note 9, at 4 (“The types of firms that private equity organizations finance—whether young start-ups hungry for capital or ailing giants that need to restructure—pose numerous risks and uncertainties that discourage other investors.”).

127. *See id.* at 1; *see also* JANET KILHOLM SMITH & RICHARD L. SMITH, *ENTREPRENEURIAL FINANCE* 471 (2d ed. 2004) (discussing the niche filled by venture capital financing and the appropriateness of debt financing).

128. LERNER ET AL., *supra* note 9, at 138–39.

129. *Id.* at 138.

130. *See* Fruhan, *supra* note 7, at 1; Bianco, *supra* note 112.

131. Rosenbush, *supra* note 91 (explaining that this strategy can work “as long as the debt levels don’t get out of hand and the owners manage to cut costs and improve operations”); *see*

histories of obtaining government contracts are thus especially attractive to PE funds because they promise “lots of cash” and can support the high levels of debt the PE fund forces on the company in the initial acquisition.

C. *The Investors and the Structure of a PE Fund*

For investors, the allure of PE lies in the potential for high returns well in excess of the market. Although risky, PE is attractive not only for very wealthy families, individuals, and trusts, but more importantly for institutional investors—including university endowments and state pension funds that manage huge amounts of capital and increasingly see PE as a legitimate way to diversify portfolios and obtain higher returns.¹³² Institutional investors are now the most significant PE investors.¹³³

These individual and institutional investors typically are considered limited partners because nearly all U.S. PE funds are organized as limited partnerships, governed by state law and the terms of their limited partnership agreements.¹³⁴ Limited partners provide about 99 percent of the capital for a PE fund and have limited liability.¹³⁵ General partners, the fund managers, provide about 1 percent of the capital for a fund,¹³⁶ and they will typically insulate themselves from personal liability by organizing as a limited liability company.¹³⁷ The primary virtue of the limited partnership structure is its pass-through tax status that avoids corporate taxation and lets limited partners and general partners pay tax at preferential capital gains tax rates, when applicable.¹³⁸ Returns on investments are called the “carried interest.” The carried interest is typically allocated 80 percent to the limited partners and

Thornton, *supra* note 91, at 61–64 (noting that PE funds use other mechanisms to accelerate the PE firm’s return or insure against loss in case of bankruptcy, including making secured loans to the company and charging management and advisory fees).

132. See SMITH & SMITH, *supra* note 127, at 469 (“Under the 1974 Employee Retirement Income Security Act (‘ERISA’) and the ‘prudent person’ standard, pension fund managers avoided making significant investments in illiquid and high-risk assets... The 1979 reinterpretation enabled managers to view the risk of an individual investment in the context of its contribution to the overall risk of the pension fund portfolio... The result was a rapid increase in the level of pension fund investing in new ventures. Other asset managers with similar fiduciary obligations, such as managers of endowment funds, have adopted the ERISA prudent investor standard.”); see also ERISA Regulations, 29 C.F.R. § 2510.3-101(d) (2007).

133. See SMITH & SMITH, *supra* note 127, at 470–71.

134. *Id.* at 468; see also Fenn et al., *supra* note 125, at 1 (“[T]he growth of private equity is a classic example of how organizational innovation, aided by regulatory and tax changes, can ignite activity in a particular market. In this case, the innovation was the widespread adoption of the limited partnership as the means of organizing private equity investments.”); LERNER ET AL., *supra* note 9, at 340 (non-U.S. PE funds tend to be modeled on U.S. PE funds, but Asian PE funds are organized as corporations).

135. See Lerner, *supra* note 105, at 1–3 (“In actuality, limited partners can only retain their limited liability if they are not involved in the day-to-day operations of the fund. Thus, once the fund is formed, they are limited to a purely consultative role, such as service on the firm’s advisory board.”).

136. See *id.* at 1–2.

137. See *id.*

138. See *Carried Interest Part I: Hearing Before the S. Comm on Finance*, 110th Cong. 8 (2007) (statement of Peter R. Orszag, Director, Cong. Budget Office) [hereinafter *Carried Interest I*].

20 percent to the general partners.¹³⁹ General partners are compensated as fund managers primarily through this allocation of the carried interest, but there are management fees and other consulting expenses that also can flow to the general partners.¹⁴⁰

A limited partnership agreement governs the relationship between the limited partners and general partners, setting precise allocation percentages, management fees, and other key terms.¹⁴¹ The limited partnership will have a fixed term of usually ten years, with the possibility of a negotiated extension.¹⁴² The agreement governs the rights of the limited partners including any rights “to terminate their investments in the partnerships under certain extreme conditions...to dissolve the partnership or replace the general partners.”¹⁴³ Additionally, the agreement may contain covenants restricting the activities of the general partners, and “[t]hese covenants can be divided into three broad classes: those relating to the overall management of the fund, the activities of the general partners, and the permissible types of investments.”¹⁴⁴

D. Trends in the PE Market

As capital commitments to PE funds reached new highs in 2006 and 2007, increasing the visibility of PE funds, there was a perfect storm in PE driven by some discernable trends in PE and the financial markets. At the same time, increased visibility exposed PE to serious criticism.¹⁴⁵ First, the most important trend has been the amount of capital committed to PE funds by large pension funds and institutional investors.¹⁴⁶ Many large institutional investors invested in mega-funds that terminated in 2005, and then rolled their returns directly into PE funds in 2006.¹⁴⁷ Second, low interest rates over the past few years, before the collapse of the subprime mortgage sector constricted the credit markets, helped PE funds finance acquisitions by permitting them to leverage deals at lower interest rates.¹⁴⁸ Third, low corporate valuations following the tech bubble and September 11, 2001, made more corporations more affordable for PE.¹⁴⁹ Fourth, low capital gains tax rates have driven more capital into the PE market, with non-501(c)(3) investors seeking income that can be

139. See SMITH & SMITH, *supra* note 127, at 478; see also *Carried Interest I*, *supra* note 138, at 8 (statement of Peter R. Orszag, Director, Cong. Budget Office); LERNER ET AL., *supra* note 9, at 22; Lerner, *supra* note 105, at 7.

140. See Thornton, *supra* note 91, at 61–63. See, generally, *Carried Interest I*, *supra* note 138, at 8 (statement of Peter R. Orszag, Director, Cong. Budget Office). But see Temporary Tax Relief Act of 2007, H.R. 3996, 110th Cong. (as passed by the House, Nov. 9, 2007).

141. See SMITH & SMITH, *supra* note 127, at 478. See, generally, Lerner, *supra* note 105, at 2.

142. See Lerner, *supra* note 105, at 2.

143. *Id.*

144. *Id.* at 3.

145. Fruhan, *supra* note 7, at 2; see also Thornton, *supra* note 91, at 59–60 (describing factors creating the PE “frenzy”); *The Business of Making Money*, *supra* note 9, at 70.

146. See Rosenbush, *supra* note 91.

147. See *id.*

148. Fruhan, *supra* note 7, at 2; *The Business of Making Money*, *supra* note 9, at 70.

149. Thornton, *supra* note 91, at 60.

characterized as long-term capital gains rather than ordinary income.¹⁵⁰ Fifth, PE funds have adopted better strategies for getting management on the side of the PE firms.¹⁵¹ Sixth, momentum in the PE market has encouraged more investment in PE as investors have searched for “better returns than stocks and bonds can provide.”¹⁵² Estimates of the amount under PE fund management went as high as \$300 billion as of the end of 2006.¹⁵³

In addition to these trends, another trend has given PE funds even more power in corporate acquisitions. Club or consortium deals have become increasingly common as PE funds finance acquisitions collectively that they would not be able to finance independently, resembling syndicated loans where lenders share large loans that they could not risk independently. These deals can increase the acquisition power of PE funds substantially.

E. Complaints About the State of the PE Market

This resurgence in PE exceeding even 1987 levels also has prompted criticism of PE. There are several major complaints about the PE market and PE funds. Given this Note’s focus on CFIUS review of acquisitions implicating national security, the most serious concern may be that PE funds are not required to identify their limited partners because PE is exempt from the disclosure requirements imposed on public companies.

There are serious complaints about PE that are fully or at least partially outside the scope of this Note, but a basic awareness of the fairness concerns,¹⁵⁴ the strategic business concerns,¹⁵⁵ and concerns over a lack of

150. See SMITH & SMITH, *supra* note 127, at 468.

151. Fruhan, *supra* note 7, at 2.

152. *Private Equity Buyout Volume Sets Record*, L.A. TIMES, July 26, 2006, at C4; see Thornton, *supra* note 91, at 59 (PE has “entered a historic period of excess”); Becky Yerack, *Exodus Ends Blair Bid for 8th Fund*, CHI. TRIB., July 29, 2006, at C1.

153. Simon, *supra* note 107.

154. Regarding fairness concerns, there is concern that PE is not fair to the less-privileged investors who are excluded from the exclusive PE world of wealthy investors with special access and special privileges. Conspiracies abound about the well-connected executives working for PE funds. The Carlyle Group, a leading PE fund in Washington, DC, has been the main target of these criticisms and has links to many former politicians and government officials who, in theory, offer access particularly in the area of government contracts.

155. Regarding strategic business and related economic concerns, there is concern over the business strategies of PE funds and some suggestion that PE funds are pushing the limits of the law. There is some concern that PE funds are engaging in opportunistic behavior. Critics complain that PE funds are not creating long-term growth as they purport to do, and there has been some “anxiety” over the impact of PE on employment. See, e.g., *Role of Private Equity*, *supra* note 110, at 2 (testimony of Josh Lerner, Jacob H. Schiff Professor of Investment Banking, Harvard Business School), available at http://energycommerce.house.gov/cmte_mtgs/110-ti-hrg.031108.Lerner-testimony.pdf. PE funds are taking new types of upfront fees or “premature dividends” that can quickly draw cash out of portfolio companies for the benefit of the fund and occasionally the general partners—without creating any immediate “value added.” See Thornton, *supra* note 91, at 61–62 (noting that a PE fund “collects a toll for giving itself advice on the deal” and may “even charge companies for no longer taking their advice [i.e., contractual early termination fees]”). In some cases, PE funds are also working with shorter time horizons than they have in the past. See *id.* at 64 (explaining how leveraged companies are being drained of cash and forced into bankruptcy). Combined with new types of upfront fees,

transparency¹⁵⁶ may help explain the tone of public debate over PE. A less-discussed aspect of this third type of concern—broadly, the concern over a lack of transparency in PE funds and in the PE market—is the fact that it is very difficult to obtain information about the identity of limited partners. This is important because CFIUS focuses on the identity of investors and PE funds effectively insulate or obscure the identity of investors. The lack of transparency into the limited partnership itself—including the identity of the limited partners, the identity of the funds’ managers, and the terms of the limited partnership agreement—is one of many features that make a PE fund acquisition very different from a traditional acquisition of one operating company by another. It is not immediately obvious whether this structural difference—specifically, the added layer of a limited partnership agreement—sufficiently quarantines any foreign investors or foreign fund managers from access to information or corporate control over a company related to national security.¹⁵⁷ Thus, this Note will argue that certain information about PE funds should be available to CFIUS for *every* transaction PE funds undertake that might implicate national security, in order to strike the right balance between national security and open markets.

IV. APPLICATION OF CFIUS TO PE

The CFIUS review process explicitly applies to traditional M&A where one operating company acquires another operating company, but it is not clear

shorter-term investments can make PE funds resemble what Warren Buffett has called “‘deal flippers,’ uninterested in building long-term value.” Geoffrey Colvin & Ram Charan, *Private Equity, Private Lives*, CNNMONEY.COM, Nov. 27, 2006, available at http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm. Even the U.N. has expressed concern about this activity. Thornton, *supra* note 91, at 64 (“[T]he U.N. issued a warning about the potential economic dangers facing companies because of private equity firms’ short investment time horizons.”). Other mechanisms push the limits of the law as PE funds use “creative” techniques to overleverage portfolio companies. *Id.* at 62–64. Also, the unprecedented level of acquisition activity through club deals has attracted the attention of federal regulators and “the Justice Department is already investigating possible collusion in bidding for companies.” Colvin & Charan, *supra*. This criticism provides important background because it identifies certain doubts about the “value added” by PE.

156. The third area of criticism concerns the lack of transparency in PE funds. The most common criticism in this area deals with the lack of transparency regarding the PE fund’s portfolio, including performance data of the fund and the list of investments in the portfolio. See Adrienne Carter, *Private Equity Wants to Stay That Way*, BUSINESSWEEK.COM, Feb. 13, 2006, http://www.businessweek.com/magazine/content/06_07/b3971108.htm; Smith, *supra* note 106, at 11. Certain state pension funds, which are limited partners in many PE funds, have taken steps to release certain performance data under pressure to disclose investment of public money. See Carter, *supra* (noting that Ohio’s pension fund is following the lead of California’s pension fund CalPERS and Texas’s state pension fund UTIMCO in attempting to balance sunshine law (open government) requirements and a general interest in public disclosure with the insistence from PE funds that these data are proprietary).

157. In fact, the trend in limited partnership law has been to give limited partners more opportunity for control without stripping them of their limited liability status. See, generally, J. DENNIS HYNES & MARK LOWENSTEIN, AGENCY, PARTNERSHIP AND THE LLC: THE LAW OF UNINCORPORATED BUSINESS ENTERPRISES (7th ed. 2007).

whether the same process applies to acquisitions engineered by PE funds. The differential impact that the CFIUS hurdle can impose on these two types of transactions is significant and may be exacerbated by the voluntary notice system and by the lack of transparency within PE. There is ambivalence over the appropriate role of PE, but it does not seem fair to erect hurdles for potential bidders when a PE consortium or a PE fund can sweep in and complete the deal in less time than it takes for CFIUS review to commence. Additionally, to the extent that PE is engaged in flipping portfolio companies to make quick profits, it does not seem desirable to create this incentive structure. Moreover, neither Congress nor the Committee has sufficiently assessed the possible access and control problems that a PE fund with foreign ties may pose to national security. Thus, in order to strike the right balance between national security and open markets, PE funds need stronger incentives to disclose their foreign ties in the first place and the Committee needs stronger guidance for handling PE acquisitions.

A. *The Scope of Exon-Florio/CFIUS Jurisdiction: Does CFIUS Apply to PE?*

Neither post-FINSA Exon-Florio nor the *post*-FINSA CFIUS regulations explicitly deal with PE-engineered acquisitions of U.S. companies. In PE there is very little transparency and PE funds are not required to disclose the identity of their investors.¹⁵⁸ There is nothing inherently bad about limiting public disclosure of a private company's activities; however, the voluntary nature of the CFIUS application process combined with weak monitoring systems may let transactions go unnoticed and unreviewed. These transactions have the potential to similarly elude public and congressional attention that provides additional monitoring in notorious cases such as the Dubai Ports World incident.

There are several reasons why it is difficult to determine whether PE funds fall within the scope of Exon-Florio/CFIUS jurisdiction. The elements triggering CFIUS jurisdiction map more easily onto traditional acquisitions, leaving jurisdiction over PE funds (organized as limited partnerships) unclear. There are four primary elements that must be present to initially grant CFIUS jurisdiction.¹⁵⁹ These four elements carry forward into the proposed regulations, subject to certain revisions.¹⁶⁰ First, the proposed acquirer of a U.S.

158. Foreign entities that are party to club or consortium deals outside of participation as limited partners in a PE fund would not be protected as limited partners in the deal and would normally be disclosed, as seen in the recently proposed and CFIUS-blocked acquisition of 3Com by a consortium including Bain Capital and Huawei Technologies of China. See *Bain Capital Drops Its Bid for 3Com: Deal Dies on U.S. Unease over Potential Role for China's Huawei*, WALL ST. J., Mar. 21, 2008, at B6.

159. See Patrick L. Schmidt, *The Exon-Florio Statute: How It Affects Foreign Investors & Lenders in the United States*, 27 INT'L LAW. 795, 798 (1993) (suggesting that there are three main questions, taking for granted the "foreign person" requirement).

160. See Regulations Pertaining to Mergers, *supra* note 5, at 21,869–72 (using slightly modified terminology but requiring the same four primary elements, proposed regulations include

company must be a “foreign person.”¹⁶¹ In most cases, this element is undisputed.¹⁶² Second, the transaction must be an “acquisition [or transaction] under section 721.”¹⁶³ Third, the acquisition “could result in foreign control” of the U.S. company¹⁶⁴ and, fourth, the acquisition could have an effect on “national security.”¹⁶⁵ More is required to trigger CFIUS action,¹⁶⁶ but these four elements have generally been sufficient to bring a transaction within CFIUS jurisdiction.

It is not clear whether a PE fund (a limited partnership) satisfies the first element—the “foreign person” requirement—that would grant CFIUS jurisdiction. Additionally, it is not clear whether an acquisition engineered by a PE fund is an “acquisition [or transaction] under section 721”¹⁶⁷ or whether the acquisition “could result in foreign control.” Whether an acquisition may affect “national security” is a question that affects all potential acquirers equally—not just PE funds—and, as discussed briefly below, might benefit from more precision.

1. The “Foreign Person” Requirement

There is no consensus as to which aspect of a PE fund might trigger CFIUS jurisdiction as an acquisition by “foreign persons.” There are a few overlapping scenarios where a PE fund might be considered a “foreign person.” Under the proposed regulations, a slight revision of the pre-FINSA regulations, a foreign person is defined as “(a) Any foreign national, foreign government, or foreign entity; or (b) Any entity over which control is exercised or exercisable by a foreign national, foreign government, or foreign entity.”¹⁶⁸

On one hand, there are two scenarios related to the *identities* of the partners. Either the limited partners or the general partner may be considered “foreign persons” under the regulations.¹⁶⁹ In either case, these investors could

newly defined terms “U.S. business” and “covered transaction,” and revised definitions of “control” and “foreign person”).

161. 31 C.F.R. § 800.301.

162. See Schmidt, *supra* note 159, at 798.

163. 31 C.F.R. § 800.301.

164. *Id.*

165. See 50 U.S.C. app. § 2170(a). This element is not required in 31 C.F.R. § 800.301 but follows from the statute directly. The national security factors that CFIUS and the President may consider are listed in 50 U.S.C. app. § 2170(f).

166. See 50 U.S.C. app. § 2170(e) (articulating the standard for presidential action); 31 C.F.R. § 800.501(a) (articulating the standard for commencing CFIUS review), 800.501(b) (articulating the standard for commencing CFIUS investigation).

167. See 31 C.F.R. § 800.201 (pre-FINSA regulations); Regulations Pertaining to Mergers, *supra* note 5, at 21,869–72.

168. Regulations Pertaining to Mergers, *supra* note 5, at 21,871; see also 31 C.F.R. § 800.213 (pre-FINSA regulations defining a foreign person as “(a) A foreign national or (b) Any entity over which control is exercised or exercisable by a foreign interest”).

169. Regulations Pertaining to Mergers, *supra* note 5, at 21,871 (defining entity, foreign entity, and foreign government).

be “foreign persons” either because they are foreign nationals¹⁷⁰ or because they are subject to the control of foreign nationals, foreign governments, or foreign entities.¹⁷¹

On the other hand, there are two other scenarios related to the *organization* of the fund—either as a foreign limited partnership or as a foreign corporation. The PE fund’s limited partnership itself could be a non-U.S. limited partnership or a non-U.S. PE fund might not be organized as a limited partnership at all and might instead be organized as a corporation—as is common in Asian PE. Under both the pre-FINSA and the proposed CFIUS regulations, examples provided indicate that the country in which the acquirer is organized does not solely determine whether the entity is a “foreign person.”¹⁷² Further, under both the pre-FINSA and the proposed CFIUS regulations, when the country in which it is organized may exercise “full decision-making power” over the entity “through governmental interveners,” constituting “control” as defined in section 800.203, then the acquirer would be a “foreign person.”¹⁷³ Although the proposed regulations also would trigger the “foreign person” designation when foreign ownership hits 50 percent, ownership less than 50 percent is not immunized and would still be subject to the “foreign person” designation when there is control.¹⁷⁴ Thus, under both the pre-FINSA and proposed regulations, an organization seems to be a “foreign person” regardless of the country of organization when there is some aspect of foreign control. The usefulness of this “foreign person” concept is further complicated by the fact that publicly traded companies do not always have a “national character,” but the proposed regulations would bestow such national character when traded on a foreign exchange.¹⁷⁵

170. 31 C.F.R. § 800.212 (pre-FINSA regulations); Regulations Pertaining to Mergers, *supra* note 5, at 21,871.

171. Regulations Pertaining to Mergers, *supra* note 5, at 21,870 (replacing pre-FINSA “foreign interest” language with “foreign entity” language and defining foreign entity as “(a) A public company organized under the laws of a foreign state whose equity securities are traded on one or more foreign exchanges; or (b) Any other entity organized under the laws of a foreign state in which foreign nationals hold, directly or indirectly, at least 50 percent of the outstanding ownership interest in an entity”).

172. *Id.* at 21,871; *see also* 31 C.F.R. § 800.213 (pre-FINSA regulations).

173. 31 C.F.R. § 800.213 (pre-FINSA regulations); Regulations Pertaining to Mergers, *supra* note 5, at 21,871.

174. Unlike the pre-FINSA regulations, the proposed CFIUS regulations also suggest that when a company is not publicly traded, it may be a “foreign entity” (and thus a “foreign person”) where foreign nationals hold, directly or indirectly, at least 50 percent of the outstanding ownership interest. Regulations Pertaining to Mergers, *supra* note 5, at 21,870–71; *see also id.* at 21,865. This does not seem to mean that where foreign nationals hold less than 50 percent of the outstanding ownership interest it is automatically exempt from CFIUS review. Rather, under Example 5 of the proposed regulations, if there is “control,” it would still amount to a “foreign person” and trigger CFIUS review. *Id.* at 21,870.

175. Larson & Marchick, *supra* note 1, at 9 (July 2006); *see* Regulations Pertaining to Mergers, *supra* note 5, at 21,871.

Because of the general lack of transparency surrounding the CFIUS process, there is little more than anecdotal evidence to suggest that PE funds are subject to CFIUS jurisdiction. In 2003, a proposed acquisition by funds at two PE firms—Apax Partners Worldwide and Permira Advisers of Inmarsat Ventures Ltd., a company that holds government contracts with the U.S. military—was submitted for CFIUS review after Senators Inouye and Hollings and four members of the House of Representatives wrote letters encouraging the Committee to review the transaction.¹⁷⁶

While this may be the only public example of PE funds submitting to CFIUS review, it is instructive that members of Congress and SEC documents indicate that this transaction fell within CFIUS jurisdiction. It is also instructive, of course, that the PE funds themselves did not voluntarily notify the Committee and that CFIUS review came only after members of Congress wrote to the Secretary of the Treasury requesting review. Aside from the fact that Apax and Permira are PE firms based in the U.K., there is no information as to why Apax and Permira were considered “foreign persons.”

Discussing the possible divestiture requirement in the proposed Dubai Ports World deal where they “promised to sell the ports to a ‘US entity,’” a commentator considered the U.S. entity requirement and noted that “it is unclear whether a consortium of private equity companies could include a non-US private equity company, or whether investors in such companies could only be American.”¹⁷⁷ This seems to allude to precisely the uncertainty about whether a PE firm is a foreign or domestic entity. Thus, while there is uncertainty about whether PE fund acquisitions are within the scope of CFIUS jurisdiction, at the same time, there is at least some reliable evidence that they are.¹⁷⁸ There is also some evidence that they may not be providing voluntary notice to CFIUS and may be pushing the limits of the law.

The proposed regulations provide some additional guidance, perhaps suggesting that PE funds, regardless of where they are incorporated, that have foreign investors holding more than 50 percent of any acquired U.S. business are within the scope of CFIUS jurisdiction and that those with less than 50 percent would still be within the scope of CFIUS jurisdiction where there

176. See Caroline Muspratt, *U.S. Fears Satellite Firm Sale*, TELEGRAPH.CO.UK, Apr. 10, 2003, <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2003/10/04/cninmar04.xml>; see also Letter from Representatives John D. Dingell and Edward Markey to Sec’y John Snow (Oct. 2, 2003), available at <http://energycommerce.house.gov/press/108ltr56.shtml>. This case was especially strange considering that Inmarsat was a U.K. company. Documents interpreting the review note that CFIUS has jurisdiction when the company engages in interstate commerce, not merely when it is a U.S. company. See Inmarsat Finance II plc, Registration Statement (Form F-4) (Nov. 30, 2004), available at <http://www.secinfo.com/dVut2.112k6.htm>; see also Regulations Pertaining to Mergers, *supra* note 5, at 21,872 (expanding jurisdiction through the proposed definition of “U.S. business”).

177. Stephanie Kirchaessner, *CFIUS Overhaul Back in Spotlight*, FIN. TIMES, Aug. 23, 2006, <http://www.ft.com/cms/s/1523f970-32d0-11db-87ac-0000779e2340.html>.

178. See Skadden, Arps, Chicago Office: CFIUS Practice Area Detail, <http://www.skadden.com/Index.cfm?contentID=49&officeID=5&focusID=503> (last visited May 7, 2008) (advising PE consortiums on CFIUS).

was nonetheless foreign control. The proposed regulations make some gesture toward requiring PE to submit to CFIUS review, but even so, the process remains voluntary, so the effect on PE remains to be seen.

2. The “Acquisition Under Section 721”/“Transaction Under Section 721” Requirement and the “Control” Requirement

There are additional questions about when a transaction becomes an “acquisition under section 721” (or, as referred to in the proposed regulations, a “transaction under section 721”)—a concept tied to “control.” The pre-FINSA CFIUS regulations define an “acquisition” to include the acquisition of an entity through “(1) The purchase of its voting securities; (2) The conversion of its convertible voting securities; (3) The acquisition of its convertible voting securities if that involves the acquisition of control; or (4) The acquisition and the voting of proxies, if that involves the acquisition of control.”¹⁷⁹ The pre-FINSA regulations also list transactions that are “acquisitions under section 721” and those that are “not acquisitions under section 721.” Although the proposed regulations prefer the term “transaction” over “acquisition,” the meaning is similar in most material respects, with the addition of joint ventures and long-term leases to the definition of transaction.¹⁸⁰

When PE funds engineer acquisitions, they commonly use voting and preferred securities. In addition, they typically demand control of the portfolio company as the price of the capital. This allows them to control their investment in the company and eventually allows them to trigger their exit strategy by selling the portfolio company to someone else or through an IPO. PE funds typically demand a controlling interest and board seats in order to accomplish these tasks. PE funds exert additional control over their portfolio companies through the use of covenants in closing documents and stock issued to shareholders of the portfolio company.¹⁸¹ PE expert Joshua Lerner notes that

[e]ven if the private equity investors do not own greater than 50 percent of the equity, the contracts may allocate control of the board to venture capitalists... All in all, the most frequent use of covenants is to effectively disconnect control on important issues from owning a majority of the equity...¹⁸²

Under the definition of “control,” PE funds clearly have control over the “dissolution of the entity,” the “closing, relocation or substantial alteration

179. 31 C.F.R. § 800.201(a).

180. Compare Regulations Pertaining to Mergers, *supra* note 5, at 21,871 (“The term transaction means a proposed or consummated merger, acquisition, or takeover. It includes: (a) The acquisition of an ownership interest in an entity. (b) The acquisition or conversion of convertible voting instruments of an entity. (c) The acquisition of proxies from holders of a voting interest in an entity. (d) A merger or consolidation. (e) The formation of a joint venture. (f) A long-term lease under which a lessee makes substantially all business decisions concerning the operation of a leased entity, as if it were the owner.”), with 31 C.F.R. § 800.201(a).

181. See LERNER ET AL., *supra* note 9, at 295.

182. *Id.*

of the production, operational or research and development facilities...¹⁸³ The fund managers generally believe that they have something to contribute to maximize shareholder value in the company. Control is key to the PE investment strategy.

This is complicated by several factors. Although the CFIUS regulations define “control,” both the pre-FINSA and the proposed regulations reject precise bright-line tests for control out of a concern that companies would structure deals to avoid tripping those bright lines.¹⁸⁴ According to CFIUS, “[t]he proposed regulations adopt the long-standing approach of defining ‘control’ in functional terms as the ability to exercise certain powers over important matters affecting a business.”¹⁸⁵ However, mere “[a]cquisition of influence falling short [of control]” is not an “acquisition under section 721.”¹⁸⁶ The somewhat vague definition of control makes it very difficult to determine whether PE funds would trigger the control element. This is compounded by the lack of clarity as to what constitutes a foreign person.¹⁸⁷ Moreover, the trend in PE involving consortiums of PE funds adds another dimension. If the Department of Justice discovers collusion in bidding among these PE funds, it also may trigger the definition of “control” in proposed regulation 31 C.F.R. § 800.203(b) (pre-FINSA 31 C.F.R. § 800.204(b)), regarding agreements “to act in concert.”¹⁸⁸ The CFIUS regulations suggest that syndicate loans, which in theory are comparable to club deals, do not trigger CFIUS review.¹⁸⁹ However, the syndicate loan is distinguishable from a club deal because there is uncertainty as to whether the loan will eventually amount to “control,” but it is clear that parties to a club deal already have shared “control.” Also, there is a provision that exempts certain transactions that are “solely for purposes of investment.”¹⁹⁰ While this might exempt passive investment, PE fund managers take active roles in managing the companies, which would mean that this exemption would definitely not apply to fund managers. Depending on the terms of the limited partnership agreement and

183. Regulations Pertaining to Mergers, *supra* note 5, at 21,869; see 31 C.F.R. § 800.204(a)–(b).

184. Cf. 2 JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS & REORGANIZATIONS 300 (2d ed. 1995) (explaining that the status of control in joint ventures, for comparison, was intentionally left out of the Final Rule: “Exon-Florio itself is silent on joint ventures. Reference to joint ventures had been included in an earlier version of the legislation but was dropped prior to enactment. The Proposed Regulations, however, provide that if a foreign partner in a U.S. joint venture could, through its shareholding, elect a majority of the board of directors of the joint venture enterprise, then the formation of that joint venture ‘could result in foreign control of a U.S. person’ and is an acquisition subject to Exon-Florio.”).

185. Regulations Pertaining to Mergers, *supra* note 5, at 21,864.

186. *Id.*

187. As previously discussed, it is unclear whether CFIUS is concerned about the nationality of the investors—the limited partners, the general partners, or the limited partnership—or whether CFIUS is concerned about the country in which the PE fund is organized.

188. 31 C.F.R. § 800.204(b) (pre-FINSA regulations); Regulations Pertaining to Mergers, *supra* note 5, at 21,869; see, e.g., *Bain Capital Drops Its Bid for 3Com*, *supra* note 158, at B6.

189. 31 C.F.R. § 800.303(b) (pre-FINSA regulations); Regulations Pertaining to Mergers, *supra* note 5, at 21,869.

190. 31 C.F.R. § 800.219; Regulations Pertaining to Mergers, *supra* note 5, at 21,871, 21,873.

the amount of power that the limited partners have to curb or influence the actions of the general partner or exercise independent control,¹⁹¹ this exemption might not even apply to them.¹⁹² In fact, the recent prominence of sovereign wealth funds (SWFs) in the economy and in PE specifically has prompted particular attention to this issue where SWFs make minority investments in PE funds.¹⁹³ In March 2008 “Treasury officials said they can scrutinize private equity purchases funded with cash from sovereign wealth funds for security concerns. U.S. law ‘gives us the ability to look through...an intermediary investment vehicle,’ said David McCormick, Treasury Under Secretary for International Affairs.”¹⁹⁴ This statement overwhelmingly suggests that limited partners may have sufficient control to warrant CFIUS jurisdiction.

On one hand, this recent statement indicates that PE funds may come within the scope of CFIUS review when PE deals are “acquisitions [or transactions] under section 721” that would result in “control” by “foreign persons” in an area relevant to national security. On the other hand, it has certainly been less than clear up to this point whether foreign investment through PE could avoid CFIUS scrutiny for lack of “control” or classification as a “foreign person,” and it is unclear what weight this statement carries or whether it is just another aspect of the flexible approach CFIUS prefers. Furthermore, the proposed regulations’ treatment of PE is limited and discusses the control exerted by the fund over its operating company but refrains from discussing the control possibly exerted by the limited partners in the fund.¹⁹⁵ This lingering uncertainty—combined with the voluntary notice element, the lack

191. Recall that the trend in limited partnership law has been to give limited partners more opportunity for control without stripping them of their limited liability status. See, generally, HYNES & LOWENSTEIN, *supra* note 157.

192. See, e.g., BARTLETT, *supra* note 184, at 300–01, n.197 (“The purchase of voting securities ‘solely for purposes of investment’—such that the acquiring person has no intention to participate in the basic business decisions of the issuer—also is not an ‘acquisition’ under Exon-Florio if either (1) the foreign person would hold 10 percent or less of the outstanding voting securities of the U.S. entity, or (2) the purchase was made directly by a bank, trust company, insurance company, investment company, brokerage company, mutual fund, pension fund, or finance company ‘in the ordinary course of business for its own account,’ unless a significant part of that business involved acquisitions.”).

193. See *Government Funds’ Partnerships with Private Equity Could Raise Transparency Concerns*, INT’L HERALD TRIB., Mar. 3, 2008, <http://www.ihf.com/articles/ap/2008/03/03/business/NA-FIN-US-Foreign-Investment-Transparency.php> (discussing security questions raised by a possible acquisition of “Booz Allen Hamilton’s government contracts business” by the Carlyle Group, in which Abu Dhabi’s Mubadala Development Company owns a 7.5 percent stake); Stephanie Kirchgaessner et al., *Kuwait Set to Invest as Merrill Seeks \$4bn*, FIN. TIMES, Jan. 14 2008, at 1 (“News that Citi is seeking further financing from sovereign wealth funds comes as some analysts in Washington say the state-controlled funds could soon face closer scrutiny. . . . Citi and private equity groups that have received minority investments have not submitted their transactions to a voluntary review by CFIUS.”); *U.S. Treasury Releases Proposed Foreign Investment Regulations*, FORBES.COM, Apr. 21, 2008, <http://www.forbes.com/markets/feeds/afx/2008/04/21/afx4914861.html>.

194. *Government Funds’ Partnerships*, *supra* note 193 (discussing security questions raised by a possible acquisition of government contractor Booz Allen Hamilton by the Carlyle Group, in which Abu Dhabi’s Mubadala Development Company owns a 7.5 percent stake).

195. *Regulations Pertaining to Mergers*, *supra* note 5, at 21,869–70, Examples 3 and 4.

of transparency, and a tendency within the industry to push the limits of the law—may allow PE funds to easily elude CFIUS review entirely.

B. The Scope of Exxon-Florio/CFIUS Jurisdiction: Should CFIUS Apply to PE?

PE funds should be subject to mandatory CFIUS jurisdiction for several policy reasons. First, PE fund acquisitions lack transparency, making it virtually impossible in many cases to monitor the identity of the limited partners, the identity of the general partners, the terms of the limited partnership agreement, the subtle pressures exerted by prominent foreign investors or financiers, and the terms of a proposed acquisition of a portfolio company (absent antitrust or other regulatory issues raised by the merger). It is very difficult to adequately assess the national security implications of a transaction when so little information is publicly available.

Second, the GAO has ongoing concerns about the Committee's effectiveness in monitoring foreign investment. While the incentive structures are there for traditional acquisitions to voluntarily report when there is an identifiable foreign person involved in the transaction, PE funds lack the incentive because (1) despite some guidance provided by the regulations, there has been lingering uncertainty about whether PE funds fall within the CFIUS jurisdiction in the first place, and (2) it is even less likely that they will be detected. The incentive structures are broken for PE funds to self-report—a market failure in the CFIUS system with national security implications.

Third, there is a fairness argument to be made—that, without this change, a consortium of PE funds might be able to make an acquisition quickly while a consortium of domestic and “foreign persons” is bogged down in the regulatory process. This gives PE funds a major strategic advantage over other bidders because timing is such an important element in negotiating a transaction.

Finally, there is ambivalence about the role that PE plays in the business world. To the extent that PE funds are leveraging portfolio companies, extracting cash quickly, and flipping their investments, there is considerable debate over the PE fund's “value added” and the fund's ability to exact such a premium for its “management expertise.” In at least some cases, foreign companies that are interested in capitalizing on synergies and growing the business—not merely making it more “efficient” to make it ready for an IPO—may ultimately provide more stability and “value added” in the marketplace. The U.S. Government may not want to systematically give PE funds the advantage of timing when there is doubt over the better business policy.

1. Proposed Changes

To strike the right balance between national security and open markets, the Committee needs to have access to more information about PE fund transactions without substantially increasing the regulatory burden on all foreign investment. The following proposal will make the process more predictable for companies contemplating acquisitions with foreign investors, will improve government oversight of foreign investment in the United States and in

government contractors, and will reduce the business advantages that foreign investment currently has through PE over foreign businesses contemplating direct corporate acquisitions. As a general matter, the Committee should model further regulations and guidance on the Foreign Ownership, Control, or Influence (FOCI) program articulated in the DoD's National Industrial Security Program Operating Manual (NISPOM).¹⁹⁶

Most importantly, requiring some kind of mandatory CFIUS review of PE fund investments that relate to national security will improve CFIUS's monitoring abilities in tracking foreign investment. Mandatory review would require a PE fund to disclose the limited partners, the general partner, the management, and the limited partnership agreement that governs their relationships to one another. Congress should consider requiring all foreign investors and all PE funds to provide CFIUS with notice of acquisitions of U.S. companies and other companies holding government contracts where the company may be related to national security, perhaps permitting a de minimis ownership exception that requires a report to ensure initial compliance with the exception but otherwise requires no further CFIUS review.¹⁹⁷ This mandatory reporting requirement would track the Byrd Amendment that requires foreign investors affiliated with foreign governments to report to CFIUS. A de minimis ownership exception would track the Federal Communications Commission's (FCC) cap on foreign ownership. While the FCC has a 25 percent foreign ownership restriction, a more cautious de minimis exception might be 10 to 15 percent (without the limitation that it be "solely for the purpose of investment").¹⁹⁸ Additionally, because certain PE funds specialize in certain industries—for instance, a concentration in the energy industry, the communications industry, or the defense industry—it would encourage a more cooperative atmosphere if PE funds could obtain an upfront, conditional approval for ongoing transactions in that area as long as there have been no material changes in the foreign ownership or management of the fund and no material changes to the limited partnership agreement.

Additionally, to minimize the regulatory burden of the CFIUS process, especially the unpredictability of the process, the Committee should provide explicit guidance regarding possible risk mitigation options—in both PE transactions and traditional M&A transactions. The DoD has provided guidance in NISPOM and there is no reason why CFIUS cannot do the same. NISPOM lists several common arrangements to mitigate the risk of foreign ownership

196. See NISPOM, *supra* note 2, at 2-3-1 through 2-3-5.

197. This would not be the same as the proposed 50 percent "foreign entity" regulation (section 800.212), which triggers voluntary reporting at 50 percent but fails to make any preliminary reporting mandatory (even if it may in some situations give a limited exception where foreign nationals or entities own less than 50 percent and there is no control).

198. See Regulations Pertaining to Mergers, *supra* note 5, at 21,873; 31 C.F.R. § 800.302(d) (pre-FINSA regulations) (current (and proposed) 10 percent threshold only applies when ownership is solely for purposes of investment and PE investment may not qualify under that exception).

or control, including corporate governance provisions such as board resolutions, voting trust agreements, and proxy agreements, as well as enforceable security agreements such as Special Security Agreements (SSAs) and Security Control Agreements (SCAs).¹⁹⁹ Where these DoD guidelines apply to contracts involving access to classified information or facilities, it seems quite reasonable to ask for the same guidance where companies and transactions are not even at the classified level. While FINSA offers additional guidance, companies contemplating transactions with foreign parties should not have to predict what kinds of mitigation arrangements the Committee commonly finds acceptable. The FINSA amendment explicitly authorized these mitigation arrangements, so guidance to make this process more transparent and predictable may become even more important.

Moreover, the undefined concept of “national security” is problematic and imposes upfront costs on transactions when parties may simply be overly cautious. The Committee should provide explicit guidance regarding what kinds of industries or types of transactions it believes implicate national security and should consider a formal “express” (fast-track) approval option for transactions it concludes do not implicate national security. The Committee should not be required to promulgate regulations defining “national security” in the form of an exclusive and exhaustive list, which might be difficult to change in unusual cases or in cases of emergency, but the Committee should not be so averse to providing written, general guidance about its main concerns.²⁰⁰ A formal “express” approval process could alleviate some of these costs where there is unnecessary reporting in areas that do not implicate national security. The proposed regulations merely add to the list of possible industries implicating national security and do not address the possibility of a fast-track approach for transactions only marginally related to national security.²⁰¹

Additionally, the Department of the Treasury, responsible for promulgating CFIUS regulations, should amend the regulations to clarify the extent to which foreign ownership, foreign management, and foreign citizenship of directors constitute “control” by “foreign persons.” The proposed CFIUS regulations take steps in the right direction by providing significant guidance on these terms, and recent statements from CFIUS have suggested that CFIUS has jurisdiction over PE funds.²⁰² The pre-FINSA CFIUS regulations address a number of scenarios, including foreign ownership of lenders. The frequency with which PE funds are acquiring companies, the increased role of SWFs, and the amount of money involved in PE indicate the prominence of

199. See NISPOM, *supra* note 2, at 2-3-2, 2-3-3.

200. Putting this guidance in writing will not automatically expose vulnerabilities in national security. NISPOM lists factors in section 2-301 that could be combined with the factors found in 31 C.F.R. part 800 app. A, in 50 U.S.C. app. § 2170(f), and elsewhere, to provide much clearer guidance about the Committee’s risk assessment. Nevertheless, it is important to provide some guidance in order to minimize unnecessary reporting and costs.

201. Regulations Pertaining to Mergers, *supra* note 5, at 21,870, 21,878.

202. See, e.g., *U.S. Treasury Releases Proposed Foreign Investment Regulations*, *supra* note 193.

PE in the marketplace. It is time that the CFIUS regulations reflected this kind of common transaction and provided examples analogous to the foreign lender examples. Specifically, the CFIUS regulations need to provide clear guidance on the relevance of the limited partnership's country of origin and incorporation, the limited partners' countries of origin and incorporation, the general partner's country of origin and incorporation, the citizenship of any individual limited partners, the citizenship of the individuals who constitute the general partner, the citizenship of any directors from the PE fund on a portfolio company's board, and the PE fund that is not organized as a limited partnership. The CFIUS regulations also should be revised to include a clearer jurisdictional statement such as that found in NISPOM, section 2-300(a). In fact, the proposed regulations acknowledge the role of PE in proposed regulation § 800.203(c), Examples 3 and 4, but the examples fail to treat the many issues raised about how control might be exerted within the PE fund. They merely assume for purposes of the examples that the PE funds are "foreign person[s]." Additional guidance would help sort out some of these issues.

Finally, whether it comes from Congress, the Department of the Treasury, or the Committee itself, it will be important to have a stronger monitoring presence. This includes a commitment from individual agency members to report to the whole Committee transactions that have not voluntarily submitted to CFIUS review, a commitment to improve tracking of withdrawn transactions, and a commitment to stronger enforcement of risk mitigation agreements. The FINSA amendment and the proposed regulations may improve the Committee's monitoring role, but actual effort from Committee members certainly will need to follow.

2. Value of Proposed Changes

These proposed changes would permit CFIUS to monitor foreign investment more effectively, especially in light of GAO concerns about underreporting. Additionally, because regulatory hurdles can slow down foreign acquisition activity and give unregulated parties strategic advantages, requiring CFIUS notice from both foreign acquirers and unregulated PE fund acquirers would level the field. In light of the structures that most PE funds already have in the form of limited partnership agreements and the ease with which they could trigger a *de minimis* exception, compliance should not be difficult.

These proposed changes will not require large-scale public transparency of PE funds and will not impose SEC-like public disclosure requirements on them. They would simply require disclosure to the Committee—a Committee that is already entrusted with confidential and, in some cases, classified information under the existing statutory confidentiality requirement. This preliminary disclosure would indicate whether a PE fund qualified for the *de minimis* exception. Additionally, for those that do not qualify for the *de minimis* exception, the review in most cases could be very short—especially when

PE funds have become accustomed to the types of mitigation arrangements that CFIUS would require of them. PE funds can clearly integrate this regulatory change into their model without disturbing the PE market.

To the extent that a proposed transaction is an easy case where the Committee can conclude that there is no “control” by “foreign persons,” review can occur quickly—and even more quickly where the Committee concludes that the transaction does not implicate “national security.” To the extent that a proposed transaction is not an easy case and it takes a little longer to review, the Committee requires certain steps to mitigate risks, or the Committee instructs parties to the transaction that it cannot proceed—it is in precisely this case that CFIUS performs its function in the balancing of national security and open markets. As a matter of policy, PE funds should not be permitted to exempt themselves from this balancing simply because they do not have public disclosure requirements or because they are not as visibly “foreign” as an identifiable foreign acquirer.

There is some argument that the structure of the PE fund itself insulates the portfolio company sufficiently from foreign control by investors—especially by the nature of the limited partnership arrangement.²⁰³ Even assuming that the limited partners have no rights in the limited partnership and lack all ability to influence the general partners, this assumption would not necessarily hold true with foreign PE funds that are not organized under state²⁰⁴ limited partnership law in the United States. Moreover, limited partners actually retain certain rights over general partners—including but not limited to the right to terminate a general partner—and the trend in limited partnership law has been to permit more control by limited partners over the partnership. It is impossible to generalize and say that limited partners lack control in PE funds because the terms of the limited partnership agreement may vary. It is important that the Committee conduct this assessment in order to determine what access and control problems may still be relevant in the PE context and, where necessary, to limit investor access to information or investor control over the general partners.

V. CONCLUSION

Foreign investment is very important to the U.S. economy and it provides many companies with access to capital. American openness to foreign investment is also key to ensuring that foreign markets are open to American investment. With an increasingly global economy, it is important that the U.S. Government be able to deal with domestic and foreign companies to obtain the best services, technologies, and products. However, when companies with access to or control over domestic infrastructure, potentially dangerous

203. See, e.g., DEL. CODE ANN. tit. 6, §§ 17-305(b), 17-305(f) (2007).

204. PE fund limited partnerships are typically organized under Delaware or New York limited partnership law.

materials, and potentially proprietary information or technologies are bought and sold, there is some concern that foreign nationals or foreign governments may pose a threat to national security. CFIUS plays an important role in assessing whether an acquisition poses such a threat and in subsequently trying to strike the optimal balance between national security and open markets.

In light of recent criticism of CFIUS, the recent amendment to the Exon-Florio provision, and trends in PE, Congress should take this opportunity to address the needs of the evolving global economy by expressly placing acquisition activity that involves PE funds within the scope of CFIUS jurisdiction. By providing better guidance about what factors the Committee considers relevant to national security and by requiring all PE fund acquisitions related to national security to file notice with CFIUS, the Committee will be better able to strike the right balance between national security and open markets. Further, by streamlining the process and providing better guidance about Committee procedures and risk mitigation, the proposed changes minimize the regulatory impact on businesses in the case of both PE funds and more traditional acquisitions. Therefore, it is important that Congress clarify that CFIUS review is relevant to PE fund acquisitions and that Congress and the Department of the Treasury further update the Exon-Florio provision and the CFIUS regulations to reflect the changing M&A environment. Further guidance in this area is important to promote fairness, sound business policy, open markets, and national security.

Minor changes to the law governing CFIUS will make the process more predictable for companies contemplating acquisitions with foreign investors or managers, will improve government oversight of foreign investment in the United States, and will minimize the relative advantage that PE currently has over foreign businesses contemplating legitimate, direct corporate acquisitions.

