THE REGULATORY CONTEXT OF ACQUISITIONS AND INVESTMENT IN U.S. TELECOMMUNICATIONS *

by

Owen D. Kurtin & Beth Simone Noveck

A. Introduction

The Telecommunications Act of 1996 (the "Telecommunications Act"),[1] the first general telecommunications legislation in the United States since the Communications Act of 1934 (the "Communications Act")[2] was enacted to promote competition, lower entry barriers, and reduce consumer costs through both the removal of statutory and jurisprudential barriers to the cross-ownership of services in the telecommunications industry and the imposition of new duties on incumbent monopolies. The extent to which the Telecommunications Act has so far succeeded in these aims is a hotly-debated subject, but no one disputes that it has unleashed an unprecedented wave of merger and acquisition activity in the U.S. telecommunications sector.

The playing field has become more accessible to foreign entrants: the U.S. telecommunications regulator, the Federal Communications Commission ("FCC") has engaged in a process of administrative rulemaking pursuant to the Telecommunications Act intended to facilitate the entry of foreign investors. Key to this process have been the FCC's 1997 companion orders implementing the World Trade Organization ("WTO") Basic Telecommunications Agreement, liberalizing foreign ownership rules for telecommunications sector investment by WTO members in the United States (the "Foreign Participation Order")[3] and "DISCO II Order," liberalizing entry into the U.S. market for WTO member satellite operators and carriers.[4]

Notwithstanding the deregulatory intent of the Telecommunications Act, non-U.S. companies seeking entry into the U.S. telecommunications sector are still confronted by complex regulatory requirements imposed by different organs of the U.S. federal government, in some

---

* Originally Published in *TelecomFinance*, Issue 63, November 24, 1999

1 Pub. L. No. 104-104, 110 Stat. 56 (1996).

2 Pub. L. No. 73-416, 48 Stat. 1064 (1964), 47 U.S.C. §151 *et. seq.*

3 *Rules and Policies on Foreign Participation in the U.S. Telecommunications Market,* 12 FCC Rcd. 23891 (1997).

4 *Amendment of the Commission's Regulatory Policies to Allow Non-U.S.-Licensed Space Stations to Provide Domestic and International Satellite Service in the United States,* 12 FCC Rcd. 24094 (1997).

cases in apparent redundancy. The United States' federal system of government adds layers of complexity; the approval of state and local governments may be necessary for investment in U.S. telecommunications companies as well. Regulatory requirements may in many cases influence or even dictate the form and structure of an acquisition or other investment. Nevertheless, careful planning can relegate the regulatory review and approval process to a subservient role in the transaction, rather than a driving or derailing force.

The purpose of this article is not merely to enumerate principal elements of regulatory review in the United States, but to put them in context: a non-U.S. acquiror or investor must understand what U.S. regulatory authorities try to achieve in the exercise of their review and approval powers; what issues will be key to gaining their approval; and how and when should they be approached. The scope of regulatory concerns may be broadly organized into two domains: competition, and foreign ownership and national security.

B. Competition

Antitrust, or competition, law has been a preoccupation of American regulatory policy since the passage of the Sherman Antitrust Act of 1896.[5] Under the Sherman Act, every contract, combination or conspiracy in restraint of interstate or international trade is a crime.[6] Every monopoly of, attempt to monopolize, or conspiracy to monopolize, interstate or international trade is a crime.[7] Although the vigor with which different government administrations have pursued antitrust remedies has varied, the illegality of monopolies and actions in restraint of trade remains a steady theme of American law. The Microsoft antitrust trial and the Court's November 5, 1999 findings of fact[8] demonstrate that antitrust issues remain a major feature of the American legal landscape, and that the technology sector is not a new paradigm to which antitrust laws do not apply, as many pundits had opined.

Modern antitrust law in the context of mergers and acquisitions is focused not on the Sherman Act, but on Section 7 of the Clayton Act [9] and the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended ("Hart-Scott-Rodino").[10]

I. Hart-Scott-Rodino

Hart-Scott-Rodino requires the parties to certain qualifying acquisitions of any voting securities or assets of the acquired party to notify the U.S. Federal Trade Commission ("FTC")

5 15 U.S.C. §1 *et seq.*

6 *Id.*, at §1.

7 *Id.*, at §2.

8 *U.S. v Microsoft Corp.*, 98 Civ. 1232 (TPJ) (D.D.C. November 5, 1999).

9 15 U.S.C. §18.

10 15 U.S.C. §18a, codified as Section 7A of the Clayton Act.

and Department of Justice ("DOJ") of the transaction and await the expiration of a mandatory waiting period (30 days generally, 15 days in the case of a cash tender offer) prior to the closing. Hart-Scott-Rodino reporting obligations arise when: (a) either the acquiring or the acquired person is engaged in U.S. commerce or in an activity affecting U.S. commerce; and (b) (i) the company whose voting securities or assets are being acquired has total assets or annual net sales (in the case of a manufacturer) of $10 million or more and the acquiring company has total assets or annual net sales of $100 million or more; or (ii) the company whose voting securities or assets are being acquired has total assets or annual net sales of $100,000,000 or more and the acquiring company has total assets or annual net sales of $10,000,000 or more; and (c) the acquiring company, after closing, will hold: (i) 15% or more of the acquired company's voting securities *or* assets or; (ii) an aggregate of more than $15 million of the acquired company's voting securities *and* assets.[11] It is important to note that the qualification "voting securities" exempts bonds, notes, mortgages, and similar instruments and is limited to securities allowing the owner or holder to vote for directors, or analogous persons in the case of unincorporated entities. Also, rules and regulations assess the $100 million and $10 million total asset and annual net sales thresholds with reference not only to the party to the transaction, but to the total assets or annual net sales of companies or individuals under an "ultimate parent entity" with "control" established by 50% ownership of voting rights or rights to distribution.

A joint venture in which a juridical entity is formed to embody the joint venture can activate Hart-Scott-Rodino's reporting requirements, because the statute treats each joint venture participant as an acquiring person and the joint venture entity that is formed as an acquired person. Reporting requirements may be activated if either: (a) (i) the joint venture participant has gross assets or net sales of $100 million or more; (ii) the joint venture entity will have assets of $10 million or more; and (iii) at least one other joint venture participant has annual gross assets or net sales of $10 million or more; or (b) (i) the joint venture participant has total gross assets or net sales of $10 million or more; (ii) the joint venture entity will have total assets of $100 million or more; and (iii) at least one other joint venture participant has annual total gross assets or net sales of $10 million or more.[12]

The formation of a partnership ordinarily does not require a Hart-Scott-Rodino filing, subject to the rule concerning acquisition of the voting securities for any issuer included in the partnership. The formation of a limited liability company ("LLC"), a recently developed business form in the United States that combines the limited liability of a corporation with the pass-through taxation of a partnership, may trigger Hart-Scott-Rodino reporting obligations if two or more pre-existing, separately controlled businesses are contributed and at least one of the

---

11 In a Senate hearing on November 4, 1999, Senator Orrin Hatch (R-Utah) announced a proposed amendment (*Hart-Scott-Rodino Antitrust Improvements Act of 1999*, S.1854) to Hart-Scott-Rodino to raise the thresholds to which reporting requirements apply to reflect current economic realities. Available at http://thomas.loc.gov.

12 16 C.F.R. §801.40.

"members" controls the LLC in that it has a 50% "membership interest" or a right to 50% of the LLC's assets on dissolution.[13]

Exemptions from Hart-Scott-Rodino filings exist, notably for transactions in the ordinary course of business and in the case of an acquisition of 10% or less of an issuer's voting securities that is made strictly for investment purposes. During the mandatory waiting period, the FTC or DOJ may request from the parties additional documentation and extensions of the waiting period. Once documentation requests have been fully complied with, upon a finding that the proposed acquisition violates Section 7 of the Clayton Act, discussed below, the FTC or DOJ may move within twenty days for an injunction to block the proposed acquisition.

II. Clayton Act

Section 7 of the Clayton Act prohibits acquisitions, directly or indirectly, of the whole or any part of the stock or assets of any company if "the effect of such acquisition, of such stocks or assets, or of the use of such stock by the voting or granting of proxies or otherwise, may be substantially to lessen competition, or tend to create a monopoly."[14] Pursuant to Section 11 of the Clayton Act, the FCC has jurisdiction to enforce compliance with Section 7 of the Clayton Act when it is applicable to "common carriers engaged in wire or radio communication or radio transmission of energy."[15] The FCC, in performing Clayton Act review, has access to the documentation produced to the DOJ in the Hart-Scott-Rodino reporting process, but conducts its own evidentiary hearings as well.

In practice, concurrent compliance and enforcement review of telecommunications mergers and acquisitions is performed by the DOJ and the FCC, a seemingly redundant time and expense-consuming process that has generated a great deal of industry and congressional complaint. However, the two agencies have different mandates and agendas in performing their respective reviews, notwithstanding the common statutory foundation. The DOJ in its review process employs the 1992 Joint DOJ/FTC Horizontal Merger Guidelines,[16] which provide for measurement of specific product and geographic markets to determine the extent to which the proposed transaction will increase market concentration and decrease competition. Under the Horizontal Merger Guidelines, the primary analysis is based upon the ability of consumers in a given market to switch to other goods or services, whether supplied from that market or otherwise.

The FCC tends to focus on more strategic, less compartmentalized trends within the telecommunications industry and employs a "public convenience, interest or necessity" standard to determine whether approval should be granted. In a general sense, the DOJ performs a "nega-

---

13 FTC Notice of Amendment of Formal Interpretation 15, 16 C.F.R. §803.30, July 1, 1999.

14 15 U.S.C. §18.

15 15 U.S.C. §21.

16 57 Fed. Reg. 41552-01.

tive" review to determine whether competition will be decreased by the proposed acquisition; the FCC performs a "positive" review to determine whether the public interest will be served by the proposed acquisition. Clearly, notwithstanding the common statutory foundation of the Clayton Act and the data developed by Hart-Scott-Rodino reporting, the approaches taken before the DOJ and the FCC may be markedly different.

State commissions are also empowered to review proposed mergers and acquisitions on competition grounds for intrastate communications. Telecommunications mergers and acquisitions are subject to state regulatory review in every jurisdiction in which the target and acquiror have operations, and are subject to heightened scrutiny in jurisdictions in which the two have overlapping operations. State public utility commissions usually require the filing of certificates of public convenience and tariffs as part of the approval and certification process.

C. Foreign Ownership and National Security

The United States traditionally considered telecommunications a natural monopoly and utility and barred foreign ownership of radio and broadcast facilities. Although foreign ownership restrictions have been eased, they continue to exist. The U.S. also imposes restrictions on non-U.S. investment in and export of technology with national security implications.

I. Telecommunications Act License and Authorization Ownership Restrictions

Two provisions of the Communications Act, as amended by the Telecommunications Act and implemented by the FCC, particularly affect non-U.S. acquisition and investment activity in the U.S. telecommunications sector: Sections 310[17] and 214.[18]

Section 310 concerns foreign ownership restrictions applicable to FCC licenses. An FCC radio license is required for broadcast and common carrier wireless activities in the U.S. Pursuant to Section 310(a) and (b)(1) and (2), non-U.S. governments, corporations organized under the laws of non-U.S. governments and non-U.S. persons may not own or hold broadcast or common carrier radio licenses. In addition, pursuant to Section 310(b)(3), U.S. corporations may not own or hold FCC broadcast and common carrier radio licences if more than 20% of their capital stock is owned or controlled by non-U.S. governments, non-U.S. corporations or non-U.S. persons. Under Section 310(b)(4), a U.S. corporation directly or indirectly controlled by any other corporation may not hold such licenses if more than 25% of the controlling corporation’s capital stock is owned or controlled by non-U.S. governments, non-U.S. corporations or non-U.S. persons *if* the FCC finds that the public interest will be served by the refusal or revocation of such a license. The conditional element of Section 310(b)(4), generally ignored by the FCC, has been given new life by the Foreign Participation Order.

---

17 47 U.S.C. §310.

18 47 U.S.C. §214.

The restrictions have been held to apply to general and non-insulated partners in limited partnerships.[19] It should be noted that Section 310 restricts only certain enumerated FCC licenses and permits; theoretically, if a wireline telephone company could function without a radio license, its ownership would not be restricted. Similarly, IP technology projects are not subject to such a restriction. A non-U.S. company would nevertheless require a Section 214 authorization for U.S. operations.

Section 214 provides an international service authorization procedure for U.S. operations of non-U.S. carriers or their affiliates. Pursuant to the Foreign Participation Order, the FCC has, for WTO member Section 214 applications, abandoned the former "effective competitive opportunities" ("ECO") test, a case-by-case analysis previously used to examine equivalent access, or reciprocity, for U.S. carriers in the applicant's home country, in favor of a rebuttable presumption of entry eligibility. The Foreign Participation Order put in place post-entry safeguards, in the form of quarterly traffic and revenue reporting and dominant carrier and international settlement rate benchmark classifications, to ensure that reciprocal competitiveness and access exist. An expedited Section 214 application procedure now exists for both facilities-based carriers and resellers.[20] For non-WTO member Section 214 applications, the ECO test remains in place. The Foreign Participation Order standard also applies to WTO member applications for cable landing licenses and applications to exceed the Section 310(b)(4) ownership limits.

The FCC must also approve all direct or control transfers and assignments of FCC licenses, whether in the context of an acquisition or otherwise. The general FCC procedure is to file license or control transfer applications, following which there is a public notice of acceptance, a period for comments and petitions to reject, a further period for opposition to comments and petitions, replies, and then FCC Bureau or FCC action, followed by notification of approval or rejection.

II. DISCO II

Pursuant to the DISCO II Order, WTO member satellite operators are presumptively entitled to offer service in the U.S. market for fixed and mobile services without satisfying an ECO test. The presumption is rebuttable upon a showing of competitive harm in the U.S. satellite market. The FCC may also impose conditions on license grants to address competitive concerns and deny applications that pose serious competitive risks. Direct Broadcast Service ("DBS"), Digital Audio Radio Service ("DARS") and Direct-to-Home ("DTH") services are subject to more restrictive entry conditions under DISCO II by imposition of the so-called "ECO-Sat" test. Under ECO-Sat, a non-U.S. satellite operator must affirmatively demonstrate that U.S. satellite operators have effective competitive opportunities, not only in the non-U.S.

---

19 *See, e.g., Cellwave Telephone Services L.P. v. FCC;* 30 F. 3d 1533 (D.C. Cir. 1994), *Moving Phones Partnership L.P. v. FCC,* 998 F.2d 1051 (D.C. Cir. 1993).

20 *In the Matter of Streamlining the International Section 214 Authorization and Tariff Requirements*, 11 FCC Rcd. 12884 (1996).

operator's home market, but in all "route markets" that the operator intends to serve from U.S. earth stations. ECO-Sat is not applied to WTO member route markets served by non-WTO member-licensed satellites; however, the test is applied for non-WTO member route markets.

III. Exon-Florio

There is no general law regulating foreign investment in the U.S. The most important law affecting foreign investment generally is the Exon-Florio amendment to the 1988 Omnibus Trade Bill (“Exon-Florio").[21] Exon-Florio authorizes, and in some cases mandates, the President of the United States to review, on national security grounds, mergers, acquisitions and takeovers of U.S. businesses by non-U.S. persons. The investigation is mandatory when the acquiror is "an entity controlled by or acting on behalf of a foreign government" and when the acquisition could "affect" U.S. national security.[22] This definition, it should be noted, could apply to many non-U.S. telecoms, including ones not majority state-owned, but in which the non-U.S. government retains a minority "golden share." Conversely, Exon-Florio implicates even minority investments when effective control of the target is gained. Exon-Florio review is in practice conducted under delegated executive authority by an inter-agency panel, the Committee on Foreign Investment in the United States (“CFIUS”).

Upon receipt of notice of a transaction, CFIUS has 30 days to decide whether to conduct an Exon-Florio review. If CFIUS decides to review the transaction, it then has 45 days to review and render a decision. The President then has 15 days to review and approve the CFIUS decision. Information submitted during the review process is confidential. Executive authority under Exon-Florio may be exercised only if the President finds that: (i) there is credible evidence that the non-U.S. entity "might take action that threatens to impair the national security;"[23] and (ii) other statutory authorities, including the International Emergency Economic Powers Act[24] do not provide adequate protection for national security. Upon such findings, the President may prohibit or suspend a proposed transaction, or order divestiture of a completed one. No judicial review is permitted. Because transactions not reported to CFIUS may be subsequently reviewed at any time and the divestiture sanction imposed, without the possibility of judicial review, voluntary Exon-Florio reporting in the early stages of a transaction that would grant control to a non-U.S. person and which may implicate security concerns is sound practice.

IV. Export Controls

Although the U.S. does not generally restrict export of technology, limits have been imposed on technology exports considered to have security implications. Certain telecommunica-

---

21 Pub. L. No. 100-418, 102 Stat. 1107, 1425, 50 U.S.C. §2170.

22 50 U.S.C. §2170(b).

23 50 U.S.C. §2170(e).

24 50 U.S.C. §1701-1706.

tions equipment and components, as well as information security software, including encryption products, are considered to implicate national security and are therefore subject to export restriction. Where technology export restrictions apply, acquisition of a U.S. company by non-U.S. persons may breach export controls.

The scope of restriction depends on relevant Export Administration Regulations (EAR)[25] of the U.S. Department of Commerce Bureau of Export Control. Violations of the EAR carry both civil and criminal penalties.[26] Certain technologies, deemed to be vital to national security or anti-terrorism measures, may be completely restricted in their export to a short list of countries that the U.S. Government considers to be engaged in state-sponsored terrorism. Others require an individual exporter's license for export. Even where a license is not required because a general license is already in place, some telecommunications and information technologies are subject to reporting requirements and to governmental review to obtain the necessary export license exemption. An initial assessment of licensing requirements for export of a given technology can be made by studying the Commerce Department's Control List and Country Chart.

Since the fourth plenary meeting of the Wassenaar Arrangement in 1998,[27] the United States has begun to liberalize its export restriction policy on cryptographic technologies, in part at the urging of the global electronic commerce sector. On September 16, 1999, the Clinton Administration announced its intention to liberalize restrictions further; new regulations are expected to be released in mid-December 1999. Under the new rules, any 56-bit encryption commodity or software for mass or non-mass market use may be exported to commercial firms and other non-governmental users after a technical classification review by the Commerce Department to all but seven countries. Telecommunications, Internet service providers and financial institutions may export greater than 56-bit encryption commodities and software to provide services to their own affiliates, commercial firms and non-government end users without a license. Where one firm has received a license exemption for a specific technology, another firm may also export under that license exemption. The list of products that have received license exemption is confidential. However, where a license is required, each company seeking to export must seek its own export license with full disclosure as to the technology, its uses and users.

---

25. See "Steps for Using the EAR" at 15 C.F.R. §732.1.

26 In a recent case, the McDonnell Douglas division of Boeing and China's leading aviation company were charged with export violations in the 1994 sale of nineteen machine tools for $5 million, some of which the Chinese recipient shipped to a cruise missile factory. *See, Financial Times, McDonnell Douglas Faces Export Charges,* October 20, 1999, p. 12.

27 The Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Technologies is a global multilateral arrangement approved by 33 co-founding countries in 1996. *See, www.wassenaar.org.*

D. Conclusion

The market for acquisition and investment in the U.S. telecommunications sector is rapidly liberalizing. Non-U.S. investors, while officially welcomed by the Foreign Participation Order implementing regulation, must nevertheless navigate myriad regulatory hurdles. Attention to the range of issues, planning and timing will facilitate any of the many possible forms of participation in this rapidly changing and growing sector.