Statement of Mace Rosenstein, Covington & Burling

COMMISSIONER WEINTRAUB: Thank you. Mace?

MACE ROSENSTEIN, COVINGTON & BURLING: Well, I'm the piker on this panel, obviously, because, you know, I'm just a lowly communications attorney. This isn't my space and I'm also not as smart as any of these guys, but I'll fake it, okay? So just humor me.

COMMISSIONER WEINTRAUB: Don't believe any of them when they say that.

MACE ROSENSTEIN: I practice in one of the areas that, as Professor Coates mentioned, does have an existing regime to regulate foreign investment and ownership and that's in the telecom space. So I guess that's a good thing, you know, you guys can sort of write on a blank slate here, I have a century-old statutory regime that I have to struggle with and try to adapt to modern exigencies. And I thought it might make sense, because the FCC does have a very complex statutory and regulatory and policy regime, to walk you through some of the highlights of it that they might inform some of the thinking that you guys are doing and some of the discussion that is going on today. So this is where it becomes sort of the dry, lecture portion of the program, but I think it'll be interesting.
As I mentioned, the fundamental challenge that I think the FCC faces and that practitioners in this area face and that the regulated parties face is that our law governing foreign investment, which is embodied in the Communication Act, was enacted in 1934 and it hasn't changed since. And what's even more interesting is that its underpinnings, really, its progeny, its providence can be traced back to the Radio Act of 1912, over 100 years ago, when the whole world looked different, much less our communications infrastructure and our communications policy infrastructure. Congress, in fact, first became concerned about foreign ownership of radio communications in 1912, you ready for this? There was no commercial communications infrastructure industry. They were concerned that Germany or its proxies might gain control of privately held ship-to-shore radio stations along the East Coast in the run-up to the first World War and that they might use those facilities in order to send merchant ships off course and into the shoals. That's where our problem began, if you will, because, ever since that time, the Congress and the Commission have struggled with how, to what extent, to regulate foreign investment in this sector.

So let me walk through, with you, a little bit about that statutory underpinning. And I think what you'll see is, and this may not be what this room wants to hear, because the progression, the evolution of the FCC in this area has been from strict prohibition to a much more permissive environment to the extent that now, and I'm fast forwarding, we'll get there, now, for all intents and purposes, it is possible to have 100% foreign ownership of a U.S. communications facility with certain exceptions that we can talk about.

So... since 1934, when the Communications Act was promulgated, wireless communications licenses – think broadcasters, and for our purposes today, think cell phone operators, right, anything that allows you to communicate by, over spectrum without putting a signal through a wire – has been subject to section 310 of the Act. 310 does about three different things. First, it prohibits any foreign
government or its representative or any alien or any representative of an alien (and “an alien” has the common sense definition here) or any foreign organized corporation from holding an FCC license. Period, full stop. If you’re a foreigner, if you’re a foreign corporation, much less a foreign government, you may not apply to the FCC to hold a radio license. That’s the first thing. The second thing 310 does is prohibits foreign individuals and foreign governments and foreign organized corporations from owning or voting more than 20% of the equity or voting interests in an FCC licensee. So, you can’t be a licensee outright but you can hold up to a 20% interest in a licensee, whether it’s a C Corp., whether it’s a partnership, whether it’s an LLC.

Interestingly, and we’ll sort of touch on this in a little bit, too, the FCC, notwithstanding that it's an outright and categorical limit, the FCC has determined within the last three or four years that it has discretion to forebear from enforcing that limit when it believes that the public interest warrants doing so. So, in effect, the FCC has determined that it has discretion and that hasn't been challenged to allow relaxation of that 20% statutory cap.

And then we get to section 310B4 which is the provision that has most bedeviled our industry and the FCC and which I most want to focus on today, and that has to do with the limitation of indirect investment in FCC licensees. That is, an investment in a U.S.-organized entity that itself directly or indirectly controls that licensee entity that we were talking about a second ago. Here’s what it does, and it is... I can't project it here. If you're interested, you should go back and look at it because it is one of the least artfully drafted statutory provisions I've ever come across. Admittedly, my practice area is narrow, but the Communications Act is a really big document.

Section 310B4 limits indirect foreign ownership to 25%. Okay, so it's a bump up from the direct ownership cap if the commission finds the public interest would be served by prohibiting it, right? So, a common sense reading of the statute and the statute by its terms appears to say, it's okay to own as
much as you want unless the FCC tells you that you can't. However, historically, the FCC interpreted it as a cap, as a categorical cap that could only be, if you will, waived, not the technically correct term, upon application to the FCC. So it’s an interesting tension. The FCC historically just read the statute wrong in my view and said “no, no, no, you can't own more than 25% unless you come to us.” Even though what the statute says is, you can own as much as you want unless the FCC tells you you can’t. That has been one of the challenges we dealt with with the interpretation on the application of this statute through the years.

I should note, and I don’t want to get too far down into the weeds, but it also may be relevant to some of the things that you’re going to be thinking about. The 25% limitation is calculated separately for voting and equity interests. So the FCC will run two separate calculations and must be satisfied that neither the voting prong nor the economic prong exceeds 25% in order for you to certify or for it to find you’re in compliance with the limitation.

And that equity ownership generally is calculated on an outstanding, rather than a fully diluted basis, and it generally disregards debt, including convertible debt, it disregards contingent future interests such as warrants or options until they're exercised. And over time, this will not surprise you, vehicles such as debt, including convertible debt and options and warrants, have become preferred mechanisms in the industry in order to screen ownership from the foreign ownership calculation, right? In other words, I can issue warrants to my foreign investors and until they’re exercised, they’re not relevant to, either to my disclosure to the FCC or to the FCC’s calculation of the, you know, the foreign ownership quotient. But of course because there’s an exception to every rule, the FCC also determined, goaded by Rupert Murdoch in 1995, it has discretion to pierce a nominal capital structure or it has reason to believe that that structure doesn't align, at least reasonably, that it's not on the curve with the actual locus of economic ownership.
Let’s digress there briefly. My disclaimer and disclosure here is that this was my case. You recall that Murdoch became a U.S. citizen in 1985-86 because he wanted to buy a bunch of TV stations here. And remember, under 310, he couldn’t because he wasn’t a U.S. citizen. And he arranged, shall we say, an expedited path to citizenship. That was not my part of the case. My part of the case came [laughter] my part came ten years later when a whistle blower went to the FCC and said, “Hang on. His ownership disclosures at the FCC indicated that he has 76% of the voting and equity interests,” right, because he had to keep the foreign interests below 25%. Whereas the News Corporation, an Australian company, owns the other 24%; but records indicate that he only paid $760,000 for his 76% voting control interest and the company is worth however many multiple billions of dollars. That resulted in a protracted and very difficult FCC proceeding and that case resulted in the FCC’s determination that in fact, it has the power to pierce the capital structure because what it said was “hang on, Murdoch only put down $760,000 and yet says he controls 76% of this company; 99% plus of the economic value and risk is flowing out to the shareholders of the News Corporation Limited, an Australian company.”

Here’s another behind the scenes look at the FCC. It’s a very results-driven agency, alright? They had a huge problem when they made the finding that the company was out of compliance with the statute. Because theoretically it could have led to the revocation of those licenses and would have been the end of the line for FOX, which at that time was only a few years old and had provided a fourth national broadcast network which had been a huge policy objective and initiative for the FCC for generations.

We first argued from the statute and we lost. I won’t go into that argument. We then tried to recapitalize the company using debt and we said “Okay, fine, you know, you don’t count debt, we’ll just, you know, we’ll just recapitalize and all that and the company will issue debt to News Corporation” and the FCC, looking in part to the service and tax law said “no, no, no; you can’t have a 99.9% − .1 debt
equity ratio” and so the FCC reverted to plan C which was purple cow and a waiver, right? They couldn't take the risk that Murdoch would take his chips and go home and shut down the fourth network. So they said “You know what? This is a unique situation. It's never going to recur. The public interest value of that fourth network is really important. So we will allow this structure, we will bless this structure and essentially forebear from enforcing that 25% gap under the statute, even though everybody acknowledges that it's not in compliance. So, life went on. That’s not an unusual approach for the FCC to take when they have two conflicting sort of policy objectives.

And as it happened, this is a footnote, you probably know that news Corp. has been redomiciled in Delaware. The public float has done what a public float will do over time. And over time, the attributable foreign ownership of the public float has settled down at around 25% or less. There've been a couple bumps up. The FCC has mechanisms to deal with that.

Let’s go back to history, briefly. As I mentioned, the Radio Act of 1912 completely forbade any foreign ownership. Period. Nothing. Fifteen years later, Congress in the 1927 radio act decided that they would begin to permit some foreign ownership so they set limits on direct foreign ownership, that 20% that we’ve talked about. But that’s all that they did. And the legislative history emphasized national security concerns for those restrictions and that’s something, again, that we’ve been talking about a little bit today. And in particular they wanted to prevent foreign influence over domestic communications in time of war. By 1927, of course, there was, over the air, entertainment radio, right? You could get your crystal set and you could listen to the radio. And so the concern had evolved, not just from the ship-to-shore communications that had a very sort of practical implication and consequence, but the concern had broadened to a more generalized concern that a hostile foreign power could propagandize and influence the hearts and minds of American radio listeners. But the ’27 Congress left something out. The forgot about indirect foreign ownership and of course communications lawyers
being what they are and the industry being what it is, they determined that this loophole could allow them to evade foreign restriction altogether simply by organizing a U.S. holding company, right? In ’34 that loophole was closed and that’s when we landed on the regime that we have now with the limitations 25% on indirect foreign ownership 60 or so years passed, the Commission from time to time and on a very ad hoc basis would permit foreign ownership in excess of 25%, although always in the common carrier context, the telephone context, never in the broadcast context, and I want to spend just a few minutes on that too, because I think it's relevant to what we're talking about here.

And then came the WTO in the mid-90s. And, in particular, the basic telecommunications agreement, pursuant to which, I think about 65 or 70 countries around the world undertook to open their telecommunications markets. We, of course, joined the WTO and ratified it but we took a reservation for broadcasting. We said we will only open our wireless radio markets, that is, cell phones, but we're not going to open the broadcast sector. And, in short order, after the adoption of the WTO, you saw the flood gates opening a little bit. You saw more access to foreign capital. And, I think in 2001, you saw Deutsche Telecom's acquisition of what was then called Voice Stream Wireless, which you would now know as T-Mobile, which is owned 100% by the government of Germany. Senator Hollings vociferously opposed that transaction but the FCC concluded that under the WTO, it really had no choice and could not identify any public interest harms to allowing a friendly foreign state to own a critical United States telecommunications infrastructure.

And in the years since then, that was sort of the signal event in this transition, but since that time, I think the FCC has approved 150 to 200 instances of foreign ownership of a wireless common carrier licensee in excess of 25%. They have only allowed such ownership, twice, in the broadcast context, once was Murdoch and more recently, the Pandora case, in which Pandora, you know, the music service, was seeking to acquire a terrestrial radio station, as a public company had difficulty
calculating its foreign ownership, went to the FCC and asked for permission to go to 49% which the Commission approved, subject to certain reporting and other requirements.

A couple of minutes, and I'm finishing soon, I promise. A couple minutes on this common carrier broadcast dichotomy, again because I think it might inform some of the stuff that we're talking about today. As I mentioned, you know, historically, the concern in general about foreign ownership was that foreign powers could acquire and disrupt our sort of private communications or ship to shore communications. Later, as I mentioned, with the emergence of commercial broadcasting there was a concern that foreign powers could manipulate U.S. public opinion over the radio or over television. In contrast to what the FCC has characterized as its traditionally heightened concern for foreign influence over control of licensees which exercise editorial discretion over the content of their transmissions, re: broadcasters, they've justified their willingness to consider foreign investment and common carrier licensees on the ground that they're just merely passive conduits for information provided by others.

Let's pause for a second. I'd ask you to think about whether that rationale can continue to be squared with the realities of telecommunications technology and the media marketplace in the 21st century. And, in fact, I think what you'll see is that policymakers, not just telecommunications policy makers, are becoming increasingly concerned about foreign influence, not over broadcast content (because, as we all know nobody watches broadcast television anymore anyway); but the possibility that foreign agents or hostile foreign governments could engage in cyber warfare using our communications networks. And I'd dare say that's probably trending in the right direction because communications infrastructure, think about the information that you know, they may be passive conduits, and after the open Internet decision from the court a couple of weeks ago they may be sort of locked into being passive conduits, but our communications networks control the delivery and processing of vast amounts of highly sensitive information not just for the government but for financial institutions and other
markets. And I think one could argue, you know, the Commission, if it were to reexamine these issues, might want to be shifting its focus away from broadcasting, you know, how much influence can you exercise by owning a radio station in Fargo? To our wired and unwired communications networks, given the vast quantities of data that they distribute and given their vulnerabilities from a national security perspective. In partial recognition of that reality I think starting at around 2000, 2001, the Commission started to refer transactions involving foreign investment to Team Telecom. Do you know what I mean when I talk about...? Isn't that like a great name, by the way? Like Team USA, Team Telecom, right? Team Telecom is an interagency task force comprising DOJ, FBI, Homeland Security, and Defense, which reviews every single FCC transaction involving a certain quantum of foreign investment and they review it from a national security perspective. And, in fact, the process has evolved to the point now where the FCC will either unilaterally refer a transaction out to Team Telecom or more often, we'll hear from Team Telecom as soon as the transaction is filed. And Team Telecom will instruct the FCC to put down its pen until such time that the Team Telecom national security review has been completed. Sometimes it's uneventful. Sometimes it results in what’s called a national security agreement in which the transaction parties are obligated to enter into essentially a contract with the government, regulating certain aspects of their network operations.

And now it appears from the Pandora case and a couple of other pending proceedings that that same lens will be brought to bear on broadcast transactions as well as the Commission works to rationalize its approach to foreign ownership now across sectors and is taking baby steps to harmonize its treatment of broadcasters and its treatment of common carriers. And finally, on methodology.

Because I know that is another issue. And I will shut up now. You know, once you get me started on this, it's very hard to get me to stop. But, historically, the Commission, I should say, is a very open agency, it's very transparent. There are fairly extensive disclosure obligations on applicants for new
radio stations, on applicants to sell or acquire radio stations or FCC licenses. There are periodic ownership reporting requirements of all FCC licensees, just in the ordinary course, they have to make certain disclosures about their owners. And they also have to certify compliance with the foreign ownership provisions of the communications act. That's certain junctures in a licensing process or license renewal process.

Historically the FCC has left it to licensees to determine how they're going to figure out what their foreign ownership is. Obviously in closely held corporations, they know. The commission has allowed you to rely on known shareholders, registered shareholders, management holdings. They have allowed you to conduct surveys and they will accept any survey that produces a statistically significant result but more recently they've started to legislate the types of methodology that are acceptable, in particular, in recognition of the challenge that big, global, public companies face in knowing who owns them.

And the Commission, I think, has conceded, in fact, it's very difficult – and you guys will keep me honest – for corporations to know who owns them. And I think, if you were to go carefully and review SEC filings and give it some thought, maybe do a little regression analysis, you might find that companies that nominally are in compliance with the 25% cap or believe they are, or can represent that they are, aren't. And that their foreign ownership may be well in excess of 25% from time to time or at any given time but it may be impossible for them to know that. So among those steps that the Commission is considering in a pending proceeding that was launched last October would be to accept shareholder street addresses as proxy for citizenship. Absent circumstances under which the filer has knowledge or should know that a domestic street address is being used by a foreigner. They're taking a very close look and I was in last week talking to them about whether to use the SEG-100 process, you know what that is? I can't understand it, but it is, I guess, an algorithm or software that's deployed by the depository
trust company that allows corporations to tag shares and to segregate them based on certain characteristics, in this case, whether the corporation has reason to believe that they're foreign-owned or I guess whether the holder itself acknowledges that it's foreign-owned or not.

The FCC is asking a lot of questions about that. And, in an interesting liberalization, they are reconsidering their historic position that an unknown response to a survey or an unknown shareholder must be deemed to be foreign. And among the proposals they're considering, would be some sort of proportional test that, you know, that unreported shares or unknown shares would be treated in proportion to known shares with respect to foreign versus domestic ownership. That proceeding is pending. The Commission is working very hard to rationalize its process and the industry is, I think, very engaged in trying to get to something that works both for the industry and for the agency. I'll be quiet.