

# Foreign Investment Review Under CFIUS Expands With New Legislation

October 31, 2018

## Pilot Program Mandatory Filing Requirement - Private Investment Fund Considerations

The potential for national security review of foreign investment in the U.S. has been around for 30 years since the 1988 enactment of the Exon-Florio Amendment to the Defense Production Act, which created the Committee on Foreign Investment in the U.S. ("CFIUS" or the "Committee"). *The CFIUS process is now undergoing a major overhaul and expansion as a result of the recent passage of the Foreign Investment Risk Review Modernization Act, or "FIRRMA", with the aim, according to the legislation's sponsors, to "modernize and strengthen" review by CFIUS.*

CFIUS has the authority to review "covered transactions", which, prior to FIRRMA's enactment, applied to any control transaction by or with a foreign person of a U.S. business<sup>[i]</sup>. Control is a key threshold concept under existing CFIUS regulations and FIRRMA for identifying transactions that are within the scope of review. FIRRMA codifies the existing CFIUS regulations' definition of control as "the power, direct or indirect, whether exercised or not exercised, to determine, direct, or decide important matters affecting an entity, subject to regulations prescribed by the Committee." This means even a small minority investment can potentially bring a transaction within the scope of CFIUS review, if, for example, the investor obtains rights, for instance, relating to the selection of new business lines or ventures; significant contracts; policies or procedures regarding treatment of nonpublic technical, financial, or other proprietary information; appointment or dismissal of officers or senior managers; or other significant or important rights.

However, prior to FIRRMA, filings by parties to CFIUS covered transactions were voluntary. While there were no penalties or sanctions for failure to file under the traditional CFIUS program, buyers that failed to voluntarily file left themselves open to the risk that the Committee would investigate the transaction on its own, pre or post-closing. Such investigations could result in the Committee seeking remedies, up to and including divestiture, for transactions deemed to present substantial national security issues.

## **I. FIRRMA OVERVIEW**

FIRRMA expands and strengthens the CFIUS review process in a number of important ways, including (i) new categories of covered transactions, (ii) expanded coverage of non-passive investments in "critical technology" and "critical infrastructure" companies and (iii) the requirement for mandatory filings for certain transactions.

- New categories of covered transactions (including certain real estate and bankruptcy transactions, transactions involving sensitive personal data of U.S. citizens, and changes in a foreign investor's governance rights).
- Expanded coverage of non-passive "critical technology" and "critical infrastructure" investments. The scope of potential investments was expanded beyond traditional national security and critical infrastructure investments to include other "critical technologies" such as nanotechnology, biotechnology, and emerging and foundational technologies.
- Requirement for mandatory filings for certain transactions in industries impacting critical technologies (discussed at point II below).

FIRRMA introduces new filing fees, and extended review periods beyond what is currently provided for under existing law. In addition, FIRRMA authorized CFIUS to create pilot programs to implement certain parts of FIRRMA that did not go into immediate effect.

## **II. PILOT PROGRAM AND MANDATORY FILINGS**

While most FIRRMA provisions will not go into effect until implementing regulations are established in the 2019-2020 timeframe, a CFIUS Pilot Program will begin November 10, 2018, triggering mandatory filing requirements for certain transactions, subject to a potential penalty for failure to file of up to the total value of the transaction. The requirement extends to all foreign investor transactions (without regard to dollar value, percentage interest acquired, or whether control is obtained) in a U.S. business – but only in certain enumerated sensitive U.S. industries<sup>[iii]</sup> -- that produces, designs, tests, manufactures, fabricates or develops a critical technology that is (a) utilized in connection with the U.S. business' activity in any such industry, or (b) designed by the U.S. business specifically for use in one or more such industries (a "Pilot Program U.S. Business").

Critical technologies generally means defense articles, weapons, or nuclear components, but also include certain emerging and foundational technologies controlled under the Export Control Reform Act (to be defined by regulation, but generally expected to encompass industries such as artificial intelligence, cybersecurity, virtual reality, etc.).<sup>[iii]</sup>

The Pilot Program mandatory filing requirement is limited to transactions where the foreign buyer (or indirect foreign investor) would gain control of any Pilot Program U.S. Business, including through joint venture, or would:

- <sup>i.</sup> gain access to "material nonpublic technical information"<sup>[iv]</sup> in the possession of the Pilot Program U.S. Business regarding critical technologies (information necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods, but excluding financial performance information);
- <sup>ii.</sup> obtain membership or observer rights on the board of the Pilot Program U.S. Business or the right to nominate someone to the board; or
- <sup>Bi.</sup> have involvement, other than through voting of shares, in substantive decision-making of the Pilot Program U.S. Business regarding the use, development, acquisition, or release (disclosure) of critical technology.

Parties to transactions intended to close on or after the November 10, 2018 effective date of the Pilot Program's mandatory filing requirement need to consider the impact on closing timing as the Program provides for a 45-day review period during which the transaction may not be consummated (effectively prohibiting a simultaneous sign and close).<sup>[v]</sup>

The Pilot Program mandatory filing requirement does not apply to certain other categories of businesses that were identified under FIRRMA as warranting enhanced scrutiny, including certain real estate and bankruptcy transactions, and transactions involving sensitive personal data of U.S. citizens or critical infrastructure. Also, the Pilot Program applies only to investments, and does not extend to other commercial arrangements that a foreign person may have with a Pilot Program U.S. Business, such as provision of services, sale of goods, etc.

FIRRMA directs the final implementing rules to specify criteria to limit CFIUS' application to investments for certain categories of foreign persons based on "how a foreign person is connected to a foreign country or foreign government, and whether the connection may affect the national security of the United States." Following the Pilot Program, these final regulations may limit the scope of covered transactions involving investment funds and investors from countries that do not pose a significant national security risk to the U.S. [\[vi\]](#) FIRRMA also introduced the "country of special concern" concept, which is a country with a "demonstrated or declared strategic goal of acquiring a type of critical technology or critical infrastructure that would affect United States leadership in areas related to national security." Investors associated with countries of special concern (and investment funds with limited partners associated with countries of special concern unless the exception for investment funds described below applies) should expect to receive a *higher* level of scrutiny in the review process going forward under FIRRMA.

### **III. PRIVATE INVESTMENT FUND CONSIDERATIONS**

Indirect participation by foreign investors in U.S. investments via investment funds has been potentially subject to CFIUS review since its inception, however, the CFIUS updates under FIRRMA increase the likelihood and expand the scope of such reviews.[\[vii\]](#) Subject to FIRRMA final regulations, under the Pilot Program, neither indirect participation in a U.S. investment by a "foreign person" via an investment fund as a limited partner (or equivalent), nor representation on a fund advisory board or committee, will be a covered transaction, meaning that such investments would be outside the scope of CFIUS review, provided:

- the fund is managed exclusively by a general partner or managing member that is not a "foreign person" (to be defined by the rules),

- the foreign investor does not have the ability to control the fund's investment decisions, to unilaterally select or remove (or determine the compensation of) its general partner or managing member, or to participate on an advisory board or committee of the fund that has the ability to approve, disapprove or control investment decisions of the fund, or decisions relating to entities in which the fund invests<sup>[viii]</sup>, and
- the foreign investor does not have access to "material nonpublic technical information" regarding the fund's investments and targets.

Pending FIRRMA's final regulations that define "foreign person", whether an investment fund organized in a non-U.S. jurisdiction is itself a foreign person (including by virtue of its general partner being organized in a non-U.S. jurisdiction and/or one or more of its control persons not being a U.S. national) is a fact-specific analysis.

#### **IV. OTHER TRANSACTIONS SUBJECT TO REVIEW**

*Mandatory* filings will not be required in the other areas where CFIUS has typically reviewed national security implications of transactions (e.g., banking, telecommunications, and transportation industries). However, under existing law, CFIUS review is not industry specific and transactions in all industries are potentially reviewable nonetheless if they have potential for adverse impact on critical technology or critical infrastructure that would affect United States leadership in areas related to national security. Thus, even if a transaction is not covered by the Pilot Program, it may nevertheless be subject to CFIUS review under both existing law and under the FIRRMA update. (e.g., a foreign person acquiring (directly or indirectly) a controlling or substantial minority interest in a U.S. business that potentially implicates national security or critical infrastructure). As discussed above, "control" can include the acquisition of minority interests, and even certain lending transactions, further expanding potential CFIUS review.

#### **V. CONCLUSION**

FIRRMA is the most far reaching expansion of the CFIUS review process in its history, and, coupled with new funding expected for the Pilot Program, will no doubt lead to more reviews, more investigations and more transactions that must undertake remedial measures. The final regulations will define the exact contours of which additional transactions will be subject to review, so stay tuned as we continue to evaluate the impact of these and further developments in the Pilot Program.

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[\[i\]](#) Control is not limited to majority holdings, and under existing regulations that remain in effect presently includes: "the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity . . .", 31 CFR 800.204. The definition of control is expected to be updated further under the final regulations. The term U.S. business means any entity, irrespective of the nationality of the persons that control it, engaged in interstate commerce in the United States, but only to the extent of its activities in interstate commerce. 31 CFR 800.226.

[\[ii\]](#) Under the Pilot Program Regulations, the full list of industries includes:

- Aircraft Manufacturing -- *NAICS Code: 336411*
- Aircraft Engine and Engine Parts Manufacturing -- *NAICS Code: 336412*
- Alumina Refining and Primary Aluminum Production -- *NAICS Code: 331313*
- Ball and Roller Bearing Manufacturing -- *NAICS Code: 332991*
- Computer Storage Device Manufacturing -- *NAICS Code: 334112*
- Electronic Computer Manufacturing -- *NAICS Code: 334111*
- Guided Missile and Space Vehicle Manufacturing -- *NAICS Code: 336414*
- Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing -- *NAICS Code: 336415*
- Military Armored Vehicle, Tank, and Tank Component Manufacturing -- *NAICS Code: 336992*
- Nuclear Electric Power Generation -- *NAICS Code: 221113*
- Optical Instrument and Lens Manufacturing -- *NAICS Code: 333314*
- Other Basic Inorganic Chemical Manufacturing -- *NAICS Code: 325180*
- Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing -- *NAICS Code: 336419*
- Petrochemical Manufacturing -- *NAICS Code: 325110*
- Powder Metallurgy Part Manufacturing -- *NAICS Code: 332117*
- Power, Distribution, and Specialty Transformer Manufacturing -- *NAICS Code:*

335311

- Primary Battery Manufacturing -- *NAICS Code: 335912*
- Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing -- *NAICS Code: 334220*
- Research and Development in Nanotechnology -- *NAICS Code: 541713*
- Research and Development in Biotechnology (except Nanobiotechnology) -- *NAICS Code: 541714*
- Secondary Smelting and Alloying of Aluminum -- *NAICS Code: 331314*
- Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing -- *NAICS Code: 334511*
- Semiconductor and Related Device Manufacturing -- *NAICS Code: 334413*
- Semiconductor Machinery Manufacturing -- *NAICS Code: 333242*
- Storage Battery Manufacturing -- *NAICS Code: 335911*
- Telephone Apparatus Manufacturing -- *NAICS Code: 334210*
- Turbine and Turbine Generator Set Units Manufacturing -- *NAICS Code: 333611*

[\[iii\]](#) The term critical technologies means the following: (a) Defense articles or defense services included on the United States Munitions List set forth in the International Traffic in Arms Regulations (ITAR) (22 CFR parts 120-130). (b) Items included on the Commerce Control List set forth in Supplement No. 1 to part 774 of the Export Administration Regulations (EAR) (15 CFR parts 730-774) and controlled: (1) Pursuant to multilateral regimes, including for reasons relating to national security, chemical and biological weapons proliferation, nuclear nonproliferation, or missile technology; or (2) For reasons relating to regional stability or surreptitious listening. (c) Specially designed and prepared nuclear equipment, parts and components, materials, software, and technology covered by 10 CFR part 810 (relating to assistance to foreign atomic energy activities). (d) Nuclear facilities, equipment, and material covered by 10 CFR part 110 (relating to export and import of nuclear equipment and material). (e) Select agents and toxins covered by 7 CFR part 331, 9 CFR part 121, or 42 CFR part 73. (f) Emerging and foundational technologies controlled pursuant to section 1758 of the Export Control Reform Act of 2018. 31 CFR 801.204.

[\[iv\]](#) Information that provides knowledge, know-how, or understanding, not available in the public domain, of the design, location, or operation of critical infrastructure; or is not available in the public domain, and is necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods.

[\[v\]](#) The mandatory filing requirement does not apply to any transaction for which the following has occurred before October 11, 2018: "(i) The parties to the transaction have executed a binding written agreement or other document establishing the material terms of the transaction; (ii) a party has made a public offer to shareholders to buy shares of a pilot program U.S. business; or (iii) a shareholder has solicited proxies in connection with an election of the board of directors of a pilot program U.S. business or has requested the conversion of convertible voting securities." 31 CFR 801.103(b).

[\[vi\]](#) These country specific limiting provisions of the new legislation are not yet effective, and will not be until the final regulations are in place following the expiration of the Pilot Program.

[\[vii\]](#) FIRRMA expands the scope of review in several other ways as well, including: the type of investment structure, changes in the structure of investment, control via bankruptcy and those involving sensitive personal data of U.S. citizens, changes in a foreign investor's governance rights, even in the absence of any new investment, certain real estate acquisitions or leases (including vacant land) that would allow foreign person to collect intelligence, or could otherwise expose national security activities to foreign surveillance.

[\[viii\]](#) " . . . a waiver of a potential conflict of interest, waiver of an allocation limitation, or a similar activity, applicable to a transaction pursuant to the terms of an agreement governing an investment fund shall not be considered to constitute control of investment decisions of the investment fund or decisions relating to entities in which the investment fund is invested", subject to the FIRRMA regulations that provide for exceptions in extraordinary circumstances. 31 CFR 801.304(b).

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