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UPDATE ON PROPOSED CHANGES TO THE CFIUS REVIEW PROCESS

To Our Clients and Friends:

After six months of wrangling over the fate of a proposal to modernize the process by which the Committee on Foreign Investment in the United States ("CFIUS" or the "Committee") reviews foreign investment in the United States, the U.S. Congress appears primed to streamline and modernize the CFIUS review process. Last week, committees in the Senate and the House of Representatives approved mark-ups of the proposed legislation, which will most likely be included in the National Defense Authorization Act of Fiscal Year 2019. As it currently stands, the proposed legislation would alter the CFIUS review process in many critical respects.

Background

CFIUS is an inter-agency committee authorized to review the national security implications of transactions that could result in control of a U.S. business by a foreign person ("covered transactions"), and to block transactions or impose measures to mitigate any threats to U.S. national security.[1] Established in 1975 and last reformed in 2007, observers have pointed to an antiquated regulatory framework that hinders the Committee's ability to review the particular national security implications posed by an increasing number of Chinese investments targeting sensitive technologies in the United States.

As we wrote in November 2017, the proposed Foreign Investment Risk Review Modernization Act ("FIRRMA") sought to expand the scope of transactions subject to CFIUS review and reform the process by which that review takes place.[2] Despite initial bipartisan congressional support and endorsement by the Trump administration, FIRRMA encountered a fair amount of criticism from U.S. industry groups. As originally drafted, FIRRMA would have broadened the scope of transactions subject to CFIUS review to include—among other things—outbound investments in which a U.S. company would contribute intellectual property or other support, such as joint ventures or licensing agreements, which are not currently subject to CFIUS jurisdiction. After months of intense lobbying, those provisions have been replaced by a proposal to update U.S. export controls to regulate "emerging" and "foundational" technologies. The amended version of FIRRMA also provides for short-form "light" filings, tightens the timeframe for CFIUS reviews, exempts acquirers from U.S. allies, expands the definition of "passive" investments excluded from CFIUS review, and codifies the Committee's review of real estate transactions involving sensitive government sites as well as those connected to air, land, and sea ports.

Regulating Outbound Technology Transfers Through the Export Control Process

One of the most controversial provisions of the original FIRRMA legislation was the inclusion of outbound investments—such as joint ventures or licensing agreements—in the list of covered

transactions subject to CFIUS review.[3] As originally drafted, FIRRMA would have subjected to CFIUS review any contribution (other than through an ordinary customer relationship) by a U.S. critical technology company of both intellectual property and associated support to a foreign person through any type of arrangement. Such structures are common vehicles for foreign investment, and do not trigger CFIUS jurisdiction under current regulations because they do not involve the acquisition of a U.S. business. As detailed below, the Senate ultimately retreated from this approach, opting instead to deal with such transactions through a new and enhanced set of export controls.

The Senate's amended version of FIRRMA would require the President to establish, in coordination with the Secretaries of Commerce, Defense, Energy, and State, a "regular, ongoing interagency process to identify emerging and foundational technologies" that are essential to national security but not subject to CFIUS review.[4] The Senate draft directs the Secretary of Commerce to establish controls on the export, re-export, or in-country transfer of such technology, such as requiring a license or other authorization.[5] Notably, the legislation would require a license before any covered technology is transferred to a country subject to an arms embargo, which would include technology transfers to China. If a license application is submitted on behalf of a joint venture, the Commerce Department may require the disclosure of any foreign person with significant ownership interests in the foreign entity participating in the transaction.

The House version of the proposed CFIUS legislation also includes robust export control measures in lieu of an effort to regulate outbound investments through CFIUS. As a result, the CFIUS reform legislation may provide an end-run around attempts to reform and modernize U.S. export controls, an effort that has languished on the legislative docket for decades.

Mandatory "Light" Filings and a Streamlined Review Process

Under current practice, most CFIUS reviews commence when the parties to a transaction submit a joint voluntary notice, a lengthy filing that must include detailed information about the transaction, the acquiring and target entities, the nature of the target entity's products, and the acquiring entity's plans to alter or change the target's business moving forward.[6] In practice, parties are expected to submit a "draft" notice to CFIUS prior to the commencement of the official 30-day review period, which provides the Committee and the parties with an opportunity to identify and resolve concerns before the official clock starts ticking. In recent years, this informal review process has added a degree of unpredictability in terms of timing, as the "pre-filing" phase can consume several weeks.

The current CFIUS review process includes a 30-day initial review of a notified transaction, potentially followed by a 45-day investigation period, for a possible total of 75 days. In certain circumstances, CFIUS may also refer a transaction to the President for decision, which must be made within 15 days.[7] As the volume of transactions before the Committee has increased, it has become more common for CFIUS to ask parties to refile notices at the end of the official 75-day review period, thereby restarting the clock. This has added a significant degree of uncertainty to the CFIUS review, compelling some parties to abandon deals or not to file at all.

The Senate's amended version of FIRRMA would alter this process in several key respects:

1. Mandatory "Light" Filings. In lieu of the lengthy voluntary notice required in the current CFIUS review process, FIRRMA would authorize parties to submit short form "declarations"—not to exceed 5 pages in length—at least 45 days prior to the completion of a transaction. Declarations would be mandatory in certain circumstances, such as when a foreign government holds a "substantial" interest in the foreign acquirer, or in other circumstances prescribed by the Committee.[8]

2. Exemptions. The proposed Senate bill would also allow the Committee to exempt transactions involving companies from U.S. allies, as well as those which have developed a parallel process to review the national security implications of foreign investment. Notably, parallel measures to review foreign investment have been proposed in a number of other countries. In August 2017, citing similar concerns with China's technological investments, the European Union called for more rigorous screening of foreign acquisitions involving European companies, and Germany increased the authority of its Ministry for Economic Affairs and Energy ("BMWi") to review foreign investments. And in October 2017, the United Kingdom published several legislative proposals that would increase its ability to review and intervene in transactions that raise national security considerations or involve national infrastructure.

3. Timeframe. FIRRMA would also require the Committee to respond to a declaration within a tighter time period. The Senate draft says that the Committee shall take action within 30 days of receiving a declaration,[9] whereas the House draft cuts that response time down to 15 days.[10] FIRRMA would provide for a longer initial review period, extending it from 30 to 45 days and authorizing CFIUS to extend the 45-day investigation phase by 30 days "in extraordinary circumstances."[11] In the House draft, the extension period for extraordinary circumstances is only 15 days.[12]

4. Filing Fees. The original FIRRMA bill included a provision requiring filing fees not to exceed the lesser of 1% of the value of the transaction or $300,000.[13] The Senate draft still provides for filing fees, but it is less specific as to the amount, instructing the Committee to consider the value of the transaction, the effect of the fee on small business concerns, the effect on foreign investment, and the expenses of the Committee in setting the fee.[14] The Senate draft also instructs the Committee to periodically reconsider the amount of the fee. In contrast, the House draft eliminates the proposed filing fees entirely.

5. Judicial Review. The original November 2017 version of FIRRMA would have exempted the actions and findings of the Committee from judicial review, limiting parties' ability to challenge CFIUS decisions. The amended Senate version of the bill provides that parties may challenge CFIUS actions before the U.S. Court of Appeals for D.C. Circuit.[15] The Senate draft also establishes procedures for the review of privileged or classified information via *ex parte* and *in camera* reviews.[16]

The Space Between "Control" and "Passive" Investments

The Senate draft would expand the definition of a covered transaction to include not only a transaction through which a foreign company could obtain "control" of a U.S. company, but also any "other investment (other than passive investment) by a foreign person in any United States critical technology company or United States critical infrastructure company that is unaffiliated with the foreign person."[17] Notably, current CFIUS regulations exclude transactions that result in a foreign person holding 10 percent or less of the outstanding voting interest in a U.S. business if the transaction is "solely for the purpose of a passive investment," i.e., "if the person holding or acquiring such interests does not plan or intend to exercise control, does not possess or develop any purpose other than passive investment, and does not take any action inconsistent with holding or acquiring such interests solely for the purpose of passive investment."[18] FIRRMA sought to clarify this provision by codifying a stricter definition of the term passive investment, not dependent upon the percent of ownership interest. If enacted, this change will significantly increase the types of transactions that are subject to CFIUS scrutiny.

The amended version of the Senate bill effectively expands the definition in several key ways. For example, the original FIRRMA stated that in order for an investment by a foreign person in a U.S. business to be considered passive, the foreign person could not have access to any non-public technical information or nontechnical information that was not available to all investors.[19] The amended Senate draft adds a materiality requirement and eliminates the provision on nontechnical information entirely. In the new version, the information afforded must be technical, material, and nonpublic in order for the investment to be deemed non-passive.[20] The draft Senate legislation also specifically indicates that financial information does not qualify as material nonpublic technical information.[21]

The passivity definition is of critical importance for private equity funds, and the amended Senate version of the bill accommodates such funds by excluding them from regulations that would allow CFIUS to create a test for passivity based on the size of the investment. The Senate draft also clarifies that an indirect investment by a foreign person through an investment fund that affords the foreign person membership as a limited partner on an advisory board or committee shall be considered a passive investment so long as the advisory board or committee does not have the power to approve, disapprove, or otherwise control investment decisions of the fund.[22]

Real Estate Transactions

As drafted late last year, FIRRMA sought to broaden the scope of transactions subject to CFIUS review to include the purchase or lease by a foreign person of real estate that is in close proximity to a U.S. military installation or other sensitive U.S. government facility or property. This would effectively codify the Committee's standard practice of examining the proximity of a physical property to any sensitive military or U.S. government facilities. The amended version of the Senate draft retains this provision, and includes properties connected to air, land or sea ports.[23] However, the Senate draft exempts the purchase of any 'single housing unit' as well as real estate in 'urbanized areas' as defined by the U.S. Census Bureau.[24]

Amendments A to ZTE

By the end of the Senate Banking mark-up on May 22, 2018, the Senate's draft legislation had been subject to 50 different amendments, ranging from pedestrian changes in title to substantive alterations in the original language. There was also a last-ditch attempt by Senator Van Hollen (D-MD) to push back on the Trump administration's recent effort to weaken penalties imposed on the Chinese telecom giant ZTE Corporation ("ZTE") for violations of U.S. sanctions and export controls. Notably, the amended legislation was approved by the Senate Committee on Banking, Housing, and Urban Affairs with the ZTE amendment by a unanimous vote. Some observers noted that the Senate's attempt to push back on the President's interference in the ZTE case could provide the administration with certain diplomatic cover in advance of further trade talks with the Chinese.

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[1] CFIUS operates pursuant to section 721 of the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007 (FINSA) (section 721) and as implemented by Executive Order 11858, as amended, and regulations at 31 C.F.R. Part 800.

[2] Press Release, U.S. Senator John Cornyn, Cornyn, Feinstein, Burr Introduce Bill to Strengthen the CFIUS Review Process, Safeguard National Security (Nov. 8, 2017), *available at* https://www.cornyn.senate.gov/content/news/cornyn-feinstein-burr-introduce-bill-strengthen-cfius-review-process-safeguard-national.

[3] FIRRMA Section 3(a)(5)(B)(v). The House draft includes only joint ventures that could result in the foreign control of a U.S. business in the list of covered transactions. Amendment to H.R. 5841 Section 201(3)(B)(i).

[4] Amendment to S. 2098 Section 25(a).

[5] Amendment to S. 2098 Section 25(b).

[6] 31 C.F.R. §§ 800.401(a)-(b), 800.402(c).

[7] 31 C.F.R. § 800.506.

[8] The requirements for what can trigger a mandatory declaration (the acquisition of a substantial interest in a U.S. business by a foreign person in which a foreign government has a substantial interest) are the same in both the House and Senate drafts. The definition of substantial interest is also the same. The original Senate version of FIRRMA mandated declarations for transactions involving the acquisition of a voting interest of at least 25% in a U.S. business by a foreign person in which a foreign government owns, directly or indirectly, at least a 25% voting interest. *See* FIRRMA Section 5(v)(II)(aa). Recent iterations of the bill replaced this 25% threshold with the phrase "substantial interest," to be defined by subsequent regulation, with the caveat that an interest that is a passive investment or that is less than a 10% voting interest shall not be considered a substantial interest. Amendment to S. 2098 Section 6(v)(IV)(bb)(AA)-(CC). The House bill largely parallels the

Senate bill on the use of voluntary and mandatory declarations. One linguistic change is that the Senate bill directs that the Committee "shall" prescribe regulations establishing requirements for declarations whereas the House bill says that the Committee "may" prescribe regulations for voluntary and mandatory declarations. Amendment to H.R. 5841 Section 302(a)(v)(II)(aa).

[9] Amendment to S. 2098 Section 6(v)(III)(bb).

[10] Amendment to H.R. 5841 Section 302(a)(v)(IV)(bb).

[11] Amendment to S. 2098 Section 9.

[12] Amendment to H.R. 5841 Section 303.

[13] FIRRMA Section 19.

[14] Amendment to S. 2098 Section 22.

[15] Amendment to S. 2098 Section 15.

[16] These provisions clarify parties' rights in the wake of the D.C. Circuit's 2014 decision in *Ralls Corp. v. Committee on Foreign Investment in the United States*. After CFIUS and President Obama ordered the Chinese-owned Ralls Corporation to divest a wind-farm project in close proximity to a Department of Defense facility, the D.C. Circuit held that the Committee had violated Ralls' due process rights by failing, prior to the order to divest, to provide Ralls with access to the unclassified information that the government had relied on, and to give Ralls the opportunity to rebut that unclassified information.

[17] Amendment to S. 2098 Section 3(a)(5)(B)(iii).

[18] 31 C.F.R. §§ 800.302(b), 800.223.

[19] FIRRMA Section 3(a)(5)(D)(i).

[20] Amendment to S. 2098 Section 3(a)(5)(D)(i).

[21] Amendment to S. 2098 Section 3(a)(5)(D)(ii).

[22] Amendment to S. 2098 Section 3(a)(5)(D)(iv).

[23] Amendment to S. 2098 Section 3(a)(5)(B)(ii).

[24] Amendment to S. 2098 Section 3(a)(5)(C)(i).

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