Contemporary Legal Notes

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PROPOSED CFIUS RULES:
ADDRESSING NATIONAL SECURITY ISSUES IN THE CONTEXT OF FOREIGN DIRECT INVESTMENT

by
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Washington Legal Foundation
CONTEMPORARY LEGAL NOTE Series

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ABOUT THE AUTHOR

Christopher R. Wall was until recently the senior international trade partner at Pillsbury Winthrop Shaw Pittman LLP, where he advised and represented clients in national security reviews under the Exon-Florio Amendment since the law was enacted in 1988. This paper was prepared while in private practice. On June 27, 2008, Mr. Wall was confirmed by the United States Senate and was sworn in on July 2 as Assistant Secretary of Commerce for Export Administration, where he currently serves.

The views expressed in the paper are entirely his own and do not necessarily reflect the views of the Department of Commerce or the United States Government.

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INTRODUCTION

On April 21, 2008, the U.S. Department of Treasury released proposed regulations implementing the Foreign. Enacted on July 26, 2007, FINSA amended Section 721 of the Defense Production Act of 1950, 50 U.S.C. app. § 2170, commonly known as the Exon-Florio Amendment. FINSA directed the Secretary of the Treasury to publish implementing regulations within 180 days of October 24, 2007, the effective date of the statute. Treasury published the regulations in proposed form on April 23, 2008, 73 Fed. Reg. 21861, with a 45-day period for written comments, which were due on June 9, 2008.

The proposed regulations reflect the evolution of the national security review process under the Exon-Florio Amendment as the process has developed under the current regulations codified at 31 C.F.R. Part 800 and the administrative practices of the Committee on Foreign Investment in the United States ("CFIUS").

I. NATIONAL SECURITY REVIEW PROCESS REMAINS FUNDAMENTALLY THE SAME

FINSA did not fundamentally change the structure of the Exon-Florio Amendment or the dynamics of the national security review process. CFIUS notifications are still voluntary. The standard for Presidential action continues to be based solely on national security. The review (30-day) and investigation (45-day) time periods are the same. The statute applies to the acquisition of existing U.S. businesses, not greenfield investment.

The statute did, however, make a number of procedural changes, such as: requiring more senior agency officials to be involved in CFIUS reviews; mandating investigations in certain cases unless waived by senior agency officials; formally establishing the role of the "lead agency" and involving the Office of the Director of National Intelligence in the CFIUS review process; requiring parties to certify their submissions to CFIUS; and establishing procedures for post-transaction monitoring of transactions and mitigation agreements.

FINSA also delegated a number of significant issues for interpretation and implementation. Perhaps the three most important were: (i) the use of mitigation agreements, (ii) the concept of "critical infrastructure," and (iii) "control" as it relates not only to whether a transaction will result in the foreign control of a U.S. person, but also whether a foreign government controls the acquiring party.

II. EXECUTIVE ORDER 13456 DISCIPLINED THE USE OF MITIGATION AGREEMENTS

On January 23, 2008, President Bush signed Executive Order 13456, 73 Fed. Reg. 4677 (Jan. 25, 2008), amending Executive Order 11858 of May 7, 1975, which originally established CFIUS and had been amended a number of times since to give CFIUS the authority to conduct national security reviews under the Exon-Florio Amendment. The Executive Order affirmed Treasury's principal role in the CFIUS review process. Executive Order 13456 also expanded CFIUS membership beyond the agencies mandated by FINSA to include parts of the Executive Office of the President that had previously belonged to CFIUS, such as the Office of Management and Budget, the Council of Economic Advisers, and the Office of the United States Trade Representative.

Perhaps most importantly, Executive Order 13456 made clear that mitigation agreements to address national security risks in a transaction may not be required unilaterally by a lead agency but must be approved by CFIUS. The lead agency must identify the national security risk posed by a transaction and the measures proposed to address that risk. A generalized concern that the transaction might pose an unidentified risk would not be sufficient. Specifically, a risk mitigation measure may not, except in extraordinary circumstances, require that a party "recognize, state its intention to comply with, or consent to the exercise of any authorities under existing law." In theory, this provision should ensure that foreign investors will be treated the same as domestic investors under

U.S. law consistent with the principle of national treatment.

III. CRITICAL INFRASTRUCTURE DEFINITION FOCUSES ON NATIONAL SECURITY

FINSA defined "critical infrastructure" as "systems and assets, whether physical or virtual, so vital to the United States" that their incapacity or destruction would have a "debilitating impact on national security." The proposed regulations do not expand this statutory definition or cite examples of critical infrastructure, which would in effect have declared sectors of the U.S. economy off limits to foreign investment. Rather, the proposed regulations track the statutory definition, which is tied to national security, and limit the definition to its application in the context of the particular transaction under review.

The proposed regulations do not provide much more clarity than the statute, but leave the determination of what constitutes critical infrastructure to be made on a case-by-case basis, just as the determination of national security under the Exon-Florio Amendment must be made on a case-be-case basis as well. This should send a welcome signal to foreign investors that a transaction involving an asset that might be considered critical infrastructure will be reviewed according to the same standard that has been in the law since the beginning.

IV. PROPOSED REGULATIONS CLOSELY ANALYZE CONTROL ISSUES

The Exon-Florio Amendment applies only when there is a foreign acquisition or control of a U.S. person. Thus, the analysis of control is a threshold issue. Because FINSA imposes special investigation requirements on transactions involving foreign governments, the same control analysis is relevant to determine whether the transaction involves a foreign government-controlled entity. In either case, the proposed regulations focus, as before, on a functional analysis of whether the acquiring company has the ability to direct decision making over important aspects of the acquired company's business. By focusing on control, the proposed regulations avoid making distinctions between corporate investors, private equity or sovereign wealth funds. The more important distinction is whether an investment is active or passive.

For example, the current regulations exempt from the Exon-Florio Amendment a transaction in which the foreign buyer acquires 10% of the voting stock of the target company and the acquisition is for investment purposes. This provision had often been interpreted as a safe harbor. The proposed regulations did not entirely jettison the 10% rule, as some had expected, but emphasized that the safe harbor would apply only if the investment is truly passive.

The regulations list a number of common minority shareholder protections that would not by themselves result in a finding of control, such as requiring consent to the amendment of a company's articles of incorporation or selling

substantially all of the company's assets. However, any minority shareholder protections that go beyond this narrow list could indicate that the investment is not passive and an acquisition of even less than 10% in certain circumstances could be subject to the law.

V. ADDITIONAL INFORMATION REQUIRED IN CFIUS NOTIFICATIONS

The proposed regulations formalize CFIUS practices that have evolved in recent years, such as requiring parties to provide security-related background information about the directors and senior executives of the acquiring company – ultimate parent and entities with a 5% or more interest. (This information should be submitted separately because CFIUS distributes it to a limited number of agencies for screening.) The proposed regulations also formalize the requirement to provide information about financial institutions involved in the transaction.

The notification requirements focus on foreign government involvement in the transaction. The foreign party must include information on whether a foreign government or entity controlled by a foreign government has or controls any interest in the company making the acquisition, has the power to direct corporate decision making, or has any contingent interest or other affirmative or negative powers that could be relevant to CFIUS' determination of whether the transaction is a foreign government-controlled transaction. The proposed regulations ask for a description of any formal or informal arrangements among the foreign parties to a

transaction to act in concert. In addition to birth dates, passport numbers and related information, personal identifier information must include the dates and nature of any foreign government and foreign military service of directors and senior executives.

The notification must include an organization chart of entities in the chain of ownership above the party making the acquisition, and the proposed regulations ask for the views of the acquiring party as to whether it is a foreign person, whether it is controlled by a foreign government, and whether or how control may be exercised by the foreign person or foreign government. The proposed regulations thus invite the acquiring party to advocate a position as part of the CFIUS notification. On this and other issues, parties are encouraged to engage with CFIUS informally before submitting a notification.

The information required from U.S. persons is also somewhat more detailed than the current regulations. In addition to listing by category items subject to Commerce Department export controls, the notification must list items that are or "may be" subject to the International Traffic in Arms Regulations. U.S. persons must provide an estimate of the market share for their products and services and a list of direct competitors. Finally, reflecting a term frequently encountered in mitigation agreements proposed by the Department of Homeland Security, the notification would require a description of the U.S. company's cyber security plan, if any, that will be used to protect against cyber attacks on the operation, design and development of the U.S. business' services, networks, systems, data storage

and facilities.

VI. GENERALLY POSITIVE REACTION TO PROPOSED REGULATIONS

The proposed regulations generally balance the Administration's fundamental policy of maintaining open international investment markets with the need to protect national security in the limited number of transactions where those issues arise. In a few areas, however, it would be appropriate to strike the balance slightly differently, particularly related to the issue of control. The proposed regulations potentially cast a wider net in terms of the circumstances that could constitute control. The Administration's success in implementing the law to date could be compromised by expanding the concept of control too broadly.

Striking the right balance is important because other countries are considering measures to strengthen their investment review procedures. Thus, how these regulations are finalized will serve as a benchmark and will impact how other countries will take their own measures. U.S. companies are the largest international investors and any changes to the foreign investment review procedures in the United States risk adoption of similar mirror image measures by other countries.

VII. CONTROL VS. INFLUENCE

As noted above, the proposed regulations focus closely on control in the context of whether there is a foreign acquisition of control of a U.S. person and whether a transaction is a foreign government-controlled transaction. The proposed regulations state, tautologically, that the "[a]cquisition of influence short of the definition of control over a U.S. business is not sufficient to bring a transaction under section 721." 73 Fed. Reg. 21861, 21864. In certain respects, however, the regulations appear to ascribe control to aspects of transactions that appear to amount only to influence.

A. Convertible Securities

For example, Section 800.302(b) of the proposed regulations states that the acquisition of a convertible voting instrument that does not involve control is not a covered transaction. However, the proposed regulations point to circumstances that would lead to a finding of control if, for example, the date of conversion has been agreed upon by the parties or is within the power of the acquiring entity to determine. 73 Fed. Reg. 21861, 21873. The preamble notes that these factors rather than actual conversion of the instruments would determine whether there is control. 73 Fed. Reg. 21861, 21866.

Focusing on the analysis of the circumstances under which a conversion option may be exercised reaches into the realm of influence. The fact is that control cannot be exercised until the conversion actually takes place. At that point,

the transaction would become subject to Section 721. The current regulations at 31 C.F.R. § 800.302(c) make clear that a transaction is not covered until securities are converted resulting in an acquisition of the control. Analytically, this is the proper place to draw the line.

B. Minority Shareholder Rights

Another example, noted above, relates to minority shareholder protections. The proposed regulations continue the rule under the current regulations that the acquisition of 10% of a company's voting securities is not by itself a safe harbor but could be if the transaction were only for investment purposes. In this regard, the proposed regulations identify certain negative rights that would be consistent with investment intent and would not trigger a finding of control. These are rights that are "intended to protect the investment-backed expectations of minority shareholders, and that do not affect strategic decisions on business policy or day-to-day management of any entity or other important matters affecting the entity." The list is very limited and consists of only five specific terms, although CFIUS may consider on a case-by-case basis whether any additional minority shareholder protections do not confer control. 73 Fed. Reg. 21861, 21869.

The list should include additional provisions that a minority shareholder would reasonably expect to ensure that the company in which it is making an investment does not make fundamental changes such that the value of its investment would be jeopardized. Such provisions would include requiring the investor's consent for such actions as: filing a voluntary petition in bankruptcy;

dissolving or liquidating a company or ceasing to carry on a substantial part of its business; effecting a merger or consolidation or other corporate reorganization; or increasing, adjusting, splitting, combining or reclassifying any equity securities that rank senior to the investor. The proposed regulations should state that minority board representation, in the absence of other factors, does not necessarily confer control but is only an indicator of influence. An example in the regulations to that effect would be an appropriate way to make this point.

C. Joint Ventures

Finally, regarding joint ventures, the proposed regulations determine control not on the basis of the ability to affirmatively direct the business of the entity but on the exercise of negative rights. The current regulations at 31 C.F.R. § 800.301(b)(5) provide that the formation of a joint venture into which an identifiable U.S. business is contributed is not an acquisition if both the U.S. and the foreign party have the ability to veto important decisions. Under the proposed regulations at Section 800.301(d), this analysis would be reversed. The ability to veto action would be considered an acquisition of control. The exercise of negative rights in this context should more properly be considered influence, because the U.S. and foreign parties to the joint venture would be able to direct decision making to the same extent.

VIII. COVERED TRANSACTIONS

Related to the issue of control is whether a transaction is a covered transaction, which is also a threshold issue for purposes of determining whether the law applies.

A. Internal Corporate Reorganizations

Under the current regulations at 31 C.F.R. § 302(b), a transaction in which the parent of the entity making the acquisition is the same as the parent of the entity being acquired is not a covered transaction. In the proposed regulations, this situation has been deleted. There is no commentary on the point, so it is not clear whether the deletion was intended, but it suggests that such a transaction would be considered a covered transaction. If that is indeed the case, it should not. The definition of covered transaction contemplates a change of control of a U.S. person, which would not occur in the case of an internal corporate reorganization. The same entity would be the ultimate parent before and after the transaction.

B. Leases

The proposed regulations include among the types of transactions that would be subject to Section 721 long-term leases in which "a lessee makes substantially all business decisions concerning the operation of a leased entity, as if it were the owner." The discussion of the proposed regulations indicates this would be a "very limited" type of long-term lease in which (again stated tautologically) "because of the terms of the lease and the extent of the lessee's authority over the U.S. business, the lease is effectively a transaction for purposes

of Section 721."

Infrastructure transactions involving toll roads, bridges and the like are often structured as leases, and it would be helpful for the regulations to state with greater precision exactly what factors would take a long-term lease out of the definition of transaction. The example following the definition at section 800.224(f) of the proposed regulations describes the lease of a toll road that would not be considered a transaction if the owner is "required under the agreement to perform safety and security functions with respect to the business and to monitor compliance by [the lessee] with the operating requirements of the agreement on an ongoing basis" and "may terminate the agreement or impose other penalties for breach of these operating requirements." It would appear from this example that only minimal oversight responsibilities and the ability to impose penalties in the event of a breach would be sufficient.

IX. PRELIMINARY CONTROL DETERMINATION

The determination of whether or not there is control or whether a transaction is a covered transaction is a critical threshold issue. Under current practice, however, there is no way to make this determination without preparing a full-scale notification, which requires gathering a large amount of information (discussed below), and going through the full review process, which involves an assessment of the national security implications of a transaction at the same time.[1]

[1]Section 800.403(d) of the current regulations provides for CFIUS to notify a party that a

Control, however, can be determined solely based on an analysis of the transaction documents. Similarly, a determination as to whether an entity is foreign government controlled can be made based solely on an analysis of the legislative, regulatory or other constituent documents of a government related entity. For example, a determination as to whether a private equity fund with a sovereign wealth fund ("SWF") investor is foreign government controlled (which in turn would determine whether or not any investment made by the fund would be subject to possible investigation) could be made solely on an analysis of the fund documents. Such a determination would focus on such matters as the amount of the SWF investment in the fund and the delegation of management responsibilities by the investors to the general partner or management company.

The proposed regulations encourage the parties to contact CFIUS to discuss transactions before submitting a notification. The regulations should explicitly provide for a determination of control as a threshold issue. Further, the regulations should provide for this determination to be as binding under Section 721 as a determination by CFIUS not to investigate a transaction, which thereafter protects the transaction from possible challenge on national security grounds. If CFIUS's advice is only informal, fund investors and managers will not know with certainty whether or not the fund is a foreign government-controlled entity. Parties will file defensively and subject themselves to the full review process simply

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national security review will not be conducted because the transaction is not subject to section 721. This provision seems to have been used very rarely, if ever, in practice, at least insofar as the

to obtain their CFIUS letter. Without such a binding determination, the broad sweep of the control concept in the proposed regulations will be seen as a regulatory burden and a possible deterrent to foreign investment.[2]

X. CONTENTS OF VOLUNTARY NOTICE

As discussed above, the proposed regulations increase the potential regulatory burden by expanding the information requirements for a voluntary notice. In many respects, the proposed contents mirror the current regulations, with the addition of a few questions that have become standard practice in CFIUS reviews in recent years. The proposed regulations, however, add new requirements on top of current practice and it is not clear what, if any, meaningful information will be elicited.

XI. ADDITIONAL INFORMATION FROM U.S. PERSONS

A. Government Contracts

For example, U.S. persons must list contracts with any U.S. government agency within the last three years, not just those with national defense responsibilities. For companies with limited government business, this may not be a great burden (in which case they may decide not to submit a voluntary notice),

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notification has taken the form of a formal written communication.

[2]Section 800.403(c) of the proposed regulations requires the CFIUS staff chairman to notify the parties when CFIUS has found that the transactions that is the subject of the voluntary notice is not a covered transaction. This is, however, a determination that could be made prior to and without submitting a full voluntary notice.

but it would be a burden for other companies with a large number of GSA contracts for commodity-type items. It is not clear what value information such contracts would have for purposes of a review that is intended to focus on national security.[3]

B. Export Controls

With regard to export controls, listing items that are subject to the Export Administration Regulations should not be particularly burdensome as long as the requirement applies to categories of controlled items (as provided in the proposed regulations) rather than requiring Export Control Classification Numbers for each individual product or area of technology. Listing items that have been designated as subject to, or licensed under, the International Traffic in Arms Regulations ("ITAR") is also appropriate.

The proposed regulations, however, require U.S. persons to list, in addition, items that have *not* been designated under the ITAR but *may be* so designated. This calls for purely speculative information which is, moreover, redundant since the proposed regulations continue to ask for information about products and technology that have military applications. Requiring information about military applications of products or technology is entirely appropriate and the parties can provide such objective information since they know how their products are used.

[3]By contrast, the new requirement for U.S. persons to provide an estimate of the market share for their products and services and a list of their direct competitors should not be particularly burdensome. Most companies track this type of information and it appears such information could be valuable to agencies reviewing the notice.

The parties, however, may not know where the State and Commerce Departments draw the line on jurisdiction, which is a regulatory determination that takes place behind closed doors. The only way for parties to determine ITAR jurisdiction with certainty would be to submit commodity jurisdiction requests.[4] This would impose an enormous regulatory burden that should not be a predicate for filing a voluntary CFIUS notification. The requirement to submit information on items that "may be" subject to State Department control should be deleted.

C. Cyber Security Plans

Finally, with respect to U.S. persons, the proposed regulations contain a term frequently encountered in mitigation agreements proposed by the Department of Homeland Security, requiring a description of the U.S. company's cyber security plan, if any, that will be used to protect against cyber attacks on the operation, design and development of the U.S. business' services, networks, systems, data storage and facilities. The proposed regulations should make clear that this requirement applies to the extent such a plan is required by applicable law. If the requirement is intended to imply that all companies must have such plans, it is using the national security investment review process to achieve measures that would apply only to companies subject to foreign acquisitions, which (as noted above in the context of mitigation agreements) would not be

[4]If the parties self-classified and guessed wrong, they could face the prospect of reopening a review or penalties under FINSA for submitting inaccurate information, even though based on a good faith evaluation of factors they believe relevant to the product classification.

consistent with national treatment.[5]

XII. ADDITIONAL INFORMATION FROM FOREIGN PERSONS

With regard to foreign companies involved in the transaction, the proposed regulations continue to ask for details on any arrangements regarding foreign government involvement in a transaction, and specifically ask the parties to advocate their views in that regard. Foreign parties should welcome this opportunity to expand upon and explain the details of their relationship, if any, with government entities beyond the information that may be evident from annual reports or corporate organization charts.

The proposed regulations also ask for security-related information from the directors and senior executives of the acquiring company, the ultimate parent and individuals with an interest of 5% or more in the ultimate parent. It is helpful for this requirement to be stated explicitly in the regulations. Under the current informal practice, some foreign investors have questioned whether they were being singled out for this information. It is also helpful for CFIUS to state explicitly, as has been the case in the past, that this information is subject to special confidentiality procedures over and above those that apply to the notice itself.

Unlike current practice, however, the proposed regulations ask for security-

[5]This comment is not intended to suggest one way or the other whether a company should be required to have cyber security plans, but only that the requirement to have such a plan should be applied uniformly across domestic and foreign owned companies according to the same standards.

related identifier information from any other entities in the chain of ownership that "could" exercise control over the U.S. business being acquired. Whether an entity "could" exercise control is vague. The proposed regulations should state that such information is required from the entity making the investment, from the ultimate parent and from intermediary entities only if such intermediaries in fact exercise control over the U.S. person subject to the acquisition.

Finally, a new information requirement pertains to individuals' foreign military service, where applicable. This requirement seems over-inclusive with respect to countries that require mandatory military service for those in their teens and 20s (asking for senior level military service within the past ten years or so would seem to be more relevant) and under-inclusive with respect to other countries where, in addition to the military, service in the intelligence, security or diplomatic corps at any time would be highly relevant information.[6]

XIII. PROCESS ISSUES

[6]There is also a new requirement to provide biographical information on members of the board and senior management. This requirement could presumably be satisfied by submitting CV's for the relevant individuals. It would be helpful for CFIUS to clarify how much and what sort of information is expected. It would be important as well to clarify that this information is required only when a natural person is the ultimate parent. Providing this information would present serious difficulties for foreign ultimate parents which are corporations with publicly traded securities if they have to obtain this information from directors and senior executives of companies or funds that hold 5% or more of their stock.

Also, it appears that there may be a discrepancy between this biographical information requirement, which applies to the foreign person engaged in the transaction, the immediate parent and ultimate parent of such person, while the requirement to provide personal identifier information applies only to the immediate acquirer, ultimate parent and other entities in the chain of ownership that "could" exercise control. If the immediate parent of the acquiring entity could not exercise control (e.g., it functions simply as a holding company through which the ultimate parent exercises control), it would not be necessary to submit personal identifier information on directors and senior executives, but it would apparently be necessary to submit

The proposed regulations should also address a few process issues. First, section 800.403(a)(3) of the proposed regulations requires parties to provide responsive information within two business days of requesting an extension in writing. The national security process moves very quickly and must by law be concluded within 30 days. However, a mandatory two-day response requirement is not reasonable to impose on foreign investors in all cases because of time zones, foreign holidays, etc. CFIUS should extend the response time or apply it flexibly.

Another point regarding response times pertains to CFIUS itself. There should equally be a requirement on CFIUS to provide notice to the parties whether or not a mitigation agreement will be required within a reasonable number of days prior to the end of the review period in order to provide a sufficient amount time to work out terms. CFIUS should avoid situations where parties are forced to accept terms as a last minute condition in order to avoid triggering a 45-day investigation.

Second, Section 721(c) imposes strict confidentiality obligations on CFIUS which CFIUS has scrupulously observed. It has also been CFIUS' practice to include within these confidentiality obligations information submitted to CFIUS in the context of pre-filing discussions for transactions that eventually take place. Section 702(b) of the proposed regulations applies these confidentiality protections to transactions in which notices have been withdrawn or rejected, but they do not extend such protections to transactions that ultimately do not take place. The proposed regulations encourage parties to engage CFIUS before filing a

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raphical information for these individuals.

notice. It should be clear that information provided to CFIUS in that context will be protected under Section 721(c) whether or not the transaction is eventually concluded.

FINSA imposes penalties in certain circumstances, such as the violation of the terms of a mitigation agreement, and section 800.801 of the proposed regulations provides minimal due process protections in that event. FINSA allows cases to be reopened in certain circumstances as well. However, the proposed regulations do not address the process for reopening cases at all. Some due process would be appropriate, even if it is just to provide notice and an opportunity to respond.

Finally, section 800.508 of the proposed regulations provides for the Secretary of Labor to identify on request whether any risk mitigation provisions proposed to or by the Committee would violate U.S. labor laws. This provision is anomalous. The proposed regulations should make clear, to the extent it is not already evident under Executive Order 13456, that no mitigation agreement should violate any U.S. laws, including U.S. labor laws.

CONCLUSION

As the U.S. finalizes these proposed regulations and continues to implement changes to the CFIUS review process, companies at home and overseas will be watching closely. The proposed regulations reflect a careful consideration of the

issues and should assure investors that the process will remain focused only on legitimate national security concerns. The Department of Treasury should continue its outreach efforts to reinforce that critical message and the message that the U.S. Government remains committed to an open investment climate.

