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GLOBAL TRADE UPDATE

Proposed Rules Signal A More Expansive and Intensive Examination of Foreign Investments in the United States

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On April 23, 2008, the US Department of the Treasury published its long-awaited proposed rules implementing the 2007 amendments to the US laws restricting foreign investments that may threaten US national security. The proposed rules signal that foreign investments will be subject to a more expansive and intensive examination in the months and years ahead.

Although not yet in final form, and therefore not officially in effect, in many respects the proposed rules are already in force. They reflect practices that have been adopted in recent years by the inter-agency Committee on Foreign Investment in the United States (CFIUS), the regulatory body that administers those US restrictions on foreign investment that are grounded in national security concerns. For the most part, the proposed rules simply codify the mode of operation that CFIUS has developed before and since the enactment of the Foreign Investment and National Security Act of 2007 (FINSA). (For more information on FINSA, see the July 2007 Mayer Brown Client Alert "New US law increases stringency of reviews of foreign acquisitions in the United States.")

The proposed rules are subject to public comments, which may be filed until June 9, 2008. Then the rules will be issued in final form, perhaps with revisions, at some future date. In the meantime, the proposed rules represent a guidebook to the way in which CFIUS administers its broad authority to screen foreign investments in the United States.

Expansion of the Scope of CFIUS's Examination

Specifically, the proposed rules broaden the *scope* of CFIUS scrutiny of foreign investments. They include the following significant provisions:

- **Control:** The concept of "control" is the cornerstone of the proposed rules, as CFIUS only screens those investments that would result in control by a foreign person over a US business, which control would threaten to impair national security.
- **Means of Control:** Control can be exercised not only through shareholdings and board seats but also through other

direct or indirect arrangements, including proxies, contracts, informal agreements, and other means to determine or direct major business decisions of the US business. A joint venture may be subject to CFIUS scrutiny if one party contributes a US business and a foreign person gains control over that business through the joint venture.

- **10-Percent Interest:** Significantly, the 10-percent-interest threshold, which generally had been considered the dividing line between control and no control, is expressly stated to be irrelevant unless "the transaction is solely for the purpose of investment." Thus, a foreign investor taking less than a 10-percent interest in the voting shares of a US business with national security implications would still need to establish a solely passive investment purpose.
- **Negative Power:** While the lower bounds of "control" have been erased, the proposed rules do note that certain types of negative power, generally used to protect minority shareholders' rights, will not be automatically deemed to constitute control. Types of negative power discussed in the proposed rules include: preventing the sale of all of the business's assets, preventing the business from entering into contracts with the majority owners, and preventing dilution of the minority shareholders' interests.
- **Lending Transactions:** The proposed rules state that the extension of a loan or similar financing by a foreign person to a US person, accompanied by the creation of a secured interest in securities or other assets of the US business by the foreign person, does not constitute control. Control may occur, however, if the foreign lender is the largest secured creditor in a bankruptcy of the US business. CFIUS may scrutinize transactions involving loans or financing by a foreign person when a significant possibility exists that the foreign person may obtain control of a US business due to imminent or actual default, or other similar circumstances.
- **National Security:** "National security" remains undefined under the proposed rules. Under FINSA, however, the national security is clearly implicated by foreign acquisitions of "critical technologies" or "critical infrastructure." The proposed rules define "critical technologies" as items on the US Munitions List under the International Traffic in Arms Regulations, certain controlled items under the Export Administration Regulations, nuclear items specified in the Assistance to Foreign Energy Activities and Export and Import of Nuclear Equipment and Materials regulations, and certain agents and toxins in the Export and Import of Select Agents and Toxins regulations. The proposed rules adopt the definition of "critical infrastructure" provided in FINSA and do not offer greater specificity.

Modifications of the CFIUS Process

The previously discussed adjustments in the scope of CFIUS's examination of foreign investments are accompanied by a sweeping restatement of the process by which CFIUS will conduct its examinations. With respect

to *process*, the proposed rules include the following significant provisions:

- **Pre-Notification Consultation:** While notifying CFIUS of a proposed transaction in most instances will continue to be a voluntary decision by the parties to the transaction, the proposed rules encourage the parties to confer with CFIUS in advance of a formal notification so that CFIUS can understand the transaction and provide guidance as to the information it will need to conduct the examination. Parties will now need to plan for this pre-notification consultation phase as they allocate time for satisfying regulatory preconditions to a transaction.
- **Informational Requirements:** The proposed rules update and clarify the informational requirements for CFIUS notification. Certain information that CFIUS had typically requested in the course of an examination will now be required in the initial notification, placing a greater information-gathering burden on the parties at the outset. The proposed rules specify that the notifications must contain more detailed information on the parents, affiliates, and subsidiaries of the acquiring party, on the personal identification of the directors and senior management of the acquiring party, and on critical technologies owned by the US business. Furthermore, the notifications must include a statement from the parties about their views on whether the acquiring party is controlled by a foreign government.
- **Deadlines for Responding to CFIUS Inquiries:** The pace of the CFIUS examination seems likely to quicken, with the proposed rule requiring that, within two business days, responses to any CFIUS questions be provided or an extension of time to respond be requested in writing. Given the differences in time zones that usually affect parties' response times in CFIUS examinations and the breadth of many CFIUS questions, this two-business-day rule is likely to pose challenges for parties.
- **Mitigation Agreements:** Much emphasis is placed on mitigation agreements, which will be an increasingly common condition of CFIUS clearance. These agreements between the US Government and the parties to the transaction are intended to ameliorate concerns about the national security risks of a proposed transaction. The proposed rules specify that civil penalties may be imposed for violations of mitigation agreements. Furthermore, the mitigation agreements may include provisions for liquidated damages. The threat of penalties and liquidated damages is likely to make parties all the more careful in undertaking obligations pursuant to mitigation agreements.
- **Withdrawals:** For those parties that ultimately decide that they cannot satisfy CFIUS and still preserve the commercial viability of the proposed transaction, withdrawal of the notification remains an option. The proposed rules make clear, however, that CFIUS will monitor the circumstances surrounding any

withdrawn notification to ensure that national security is not compromised by any actions of the parties following the withdrawal. These provisions will tend to make withdrawal from the CFIUS process more burdensome and inconvenient for the parties.

- **Presidential Involvement:** Finally, the proposed rules confirm that a CFIUS decision to extend an examination beyond the 30-day "review" period into the additional 45-day "investigation" period does not necessitate a referral to the President. Originally, any time a transaction could not be cleared within 30 days and was moved into the further 45-day investigation, CFIUS was required to make a recommendation to the President at the end of the investigation. CFIUS traditionally sought to shield the President from having to make such highly visible and potentially controversial decisions about particular foreign investments by minimizing the number of transactions that reached the 45-day investigation phase. The proposed rules follow the recent practice of limiting the circumstances under which CFIUS investigations need to be referred for presidential determination. Specifically, the President will be involved only if CFIUS recommends that a transaction be blocked or cannot reach a consensus on whether to make such a recommendation, or otherwise requests the President to make the determination. Because 45-day investigations no longer lead automatically to presidential involvement, the political cost of such investigations is lower and CFIUS is less likely to feel pressed to complete its examination within the original 30 days.

Exceptions and Omissions: The Privatization of US Infrastructure and Investments by Sovereign Wealth Funds

In addition to addressing the scope and process of CFIUS examinations, the proposed rules address, explicitly or implicitly, two phenomena of growing significance to foreign investors in the United States: (i) the privatization of US infrastructure, and (ii) the activity of sovereign wealth funds (SWFs).

- **Privatization of US Infrastructure:** Foreign investors have played a key role in a number of transactions through which turnpikes, bridges, and other infrastructure have been placed in private hands, typically through long-term leases. The proposed rules expressly state that long-term leases may be considered transactions that transfer control, but only where the lessee "makes substantially all business decisions concerning the operation of a leased entity, as if it were the owner." An example provided in the proposed rules notes that, where a foreign person "signs a concession agreement to operate a toll road business" in the United States "for 99 years," but where the US owner retains authority to perform "safety and security functions" and to terminate the lease if the foreign person fails to

fulfill its operational obligations under the lease, then the lease would not constitute a transaction transferring control. This provision provides to parties to infrastructure privatization transactions a road map on how to draft long-term leases that will fall outside the scope of CFIUS examination.

- **Sovereign Wealth Funds:** As to SWFs, the proposed rules make no mention of them. Some observers, including some members of Congress, had urged that the proposed rules address SWFs directly, given their growing importance in international investment flows and their potential for extending foreign government control into US energy, infrastructure, telecommunications, and other sensitive sectors. In announcing the proposed rules, however, the Treasury Department commented that CFIUS has examined SWF transactions for many years and that CFIUS intends to treat SWFs as it does any other investor controlled by a foreign government. For parties to SWF transactions, therefore, the proposed rules promise no better treatment, and no worse, than that accorded to other investments by foreign government instrumentalities.

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