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November 2018

Technology, Investment and Security: The Modernization of CFIUS

What Does it Mean for the Global Investor?

Speak to Us

Timothy Keeler
Partner
Washington DC
+1 202 263 3774
tkeeler@mayerbrown.com

Mark Uhrynuk
Partner
Hong Kong
+852 2843 4307
mark.uhrynuk@mayerbrown.com

Brian McKenna
Partner
Hong Kong
+852 2843 4355
brian.mckenna@mayerbrown.com

Thomas De Gregoris
Registered Foreign Lawyer, (Illinois, USA)
Hong Kong
+852 2843 2353
thomas.degregoris@mayerbrown.com

Mickey Leibner
Associate
Washington DC
+1 202 263 3711
mleibner@mayerbrown.com

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What Does it Mean for the Global Investor?

On August 13, 2018, President Trump signed into law the Foreign Investment Risk Review Modernization Act, or **FIRRMA**, legislation designed to enhance US national security and protect US technological achievements and superiority.

FIRRMA contains a number of provisions that modify the scope and responsibilities of the Committee on Foreign Investment in the United States, or **CFIUS**, in light of a constantly shifting economic landscape accentuated by exponential technological growth and advancement.

A Brief History

CFIUS dates back to an executive order signed by President Gerald Ford in 1975. Soon after, CFIUS developed into a multi-agency committee heavily influenced by the executive agencies of the US government responsible for the economy, national security and foreign intelligence. Thirteen years later, in 1988, the purview of CFIUS was expanded by an Act of Congress known as the Exon-Florio amendment to the Defense Production Act. Among other expansions, the effect of the Exon-Florio amendment was to give CFIUS the ability to review and prohibit any foreign acquisition of a US business that could threaten US national security.

It would be 18 years until CFIUS saw another major overhaul. What spurred this second major change was public discontent over a Dubai company's planned 2006 acquisition of a company that managed a number of US ports. This controversy prompted Congress to reform CFIUS via the Foreign Investment and National Security Act of 2007, or **FINSA**. FINSA gave Congress greater oversight over CFIUS, increased accountability among CFIUS member agencies, and expanded its scope by including critical infrastructure as part of the CFIUS national security protection mandate.

Then, in the summer of 2018, Congress enacted the FIRRMA revisions to CFIUS jurisdiction and process. FIRRMA contains a number of provisions that modify the scope and responsibilities of CFIUS to better protect US national security interests with respect to both foreign government-controlled and private investors.

Addressing Complexity — Evolving Jurisdictional Scope and Critical Focus on Technology

Generally speaking, CFIUS jurisdiction applies only to ***covered transactions***, which historically have been any merger, acquisition or takeover resulting in foreign control of any person engaged in interstate commerce in the United States. More specifically, the CFIUS mandate has been to review any covered transaction that might have an impact on US national security. Transactions where the acquiring entity is a foreign government (or controlled by a foreign government) have been given particular scrutiny. Under FIRRMA, the scope of these covered transactions has been re-assessed and expanded.

Since FINSA was enacted, CFIUS has faced a number of operational challenges as foreign investment transactions have increased both in number and complexity. In the past, transactions that fell under CFIUS jurisdiction have only included transactions that resulted in a "controlling" foreign interest. Historically, "control" meant that either the foreign person would acquire a majority interest in the US business, or that the foreign person would acquire a minority interest which resulted in a significant ability to decide important matters related to the US business (although CFIUS has found ownership at low levels – e.g., 15 percent with a board seat – sufficient to grant "control"). Under FIRRMA, however, CFIUS now has jurisdiction over certain non-controlling investments, particularly those related to ***critical technologies***, ***critical infrastructure*** or a US citizen's ***sensitive personal data***, unless the investment is truly "passive". Accordingly, under FIRRMA, even a non-controlling investment will be a covered transaction if it affords a foreign person: (i) access to ***material non-public technical information***; (ii) membership or observer rights on a board of directors or an equivalent governing body; or (iii) any involvement in substantive decision making (other than the voting of shares).

Furthermore, under FIRRMA, critical technologies include certain ***emerging and foundational technologies***. This focus on non-controlling investment and transactions involving critical technology could have potentially significant implications on a range of technology transfer transactions including joint ventures.

FIRRMA also clarifies that CFIUS jurisdiction will be triggered by any change in a foreign person's ownership or control rights in respect of a US business that could result in foreign control of a US business or an investment in a US business relating to critical technology, critical infrastructure or sensitive personal data.

The Modernization of CFIUS — Critical New Terms

Critical Technologies

Technologies that are considered uniquely sensitive for US national security and include export-controlled technologies on the United States Munitions List and the Commerce Department Control List, nuclear facilities, equipment and material, certain chemical agents and toxins and ***emerging and foundational technologies*** (see further below).

Critical Infrastructure

Systems and assets, whether physical or virtual, considered so vital to the United States that their incapacitation or destruction would have a debilitating effect on US national security; these would include communication networks, energy production, storage or distribution facilities, financial services and other sectors critical to the United States.

Sensitive Personal Data

Includes personally identifiable information and other data about US citizens that may be exploited in a manner that threatens national security; this would be expected to cover genetic information and other individual personal data that a foreign person or government may exploit in a manner that threatens national security.

Material Non-Public Technical Information

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***.

Emerging and Foundational Technologies

What constitutes emerging and foundational technologies will be determined by the US export control authorities; industry experts expect that these technologies will include artificial intelligence, robotics, navigation, autonomous vehicles and other cutting-edge technologies relevant to national security.

What About Real Estate?

Prior to FIRRMA, while the acquisition of a business in which a majority of the assets were real estate would have been subject to CFIUS jurisdiction, the mere acquisition of real estate would not have triggered a possible CFIUS review. In recent years, however, CFIUS has developed and begun to review transactions involving the acquisition of a US business in close proximity to sensitive US government facilities. Under FIRRMA, CFIUS jurisdiction has been expanded to include any type of real estate transaction in which the property is located within or in close proximity to an air or maritime port, US military installation, or any other property of the US government determined to be related to national security.

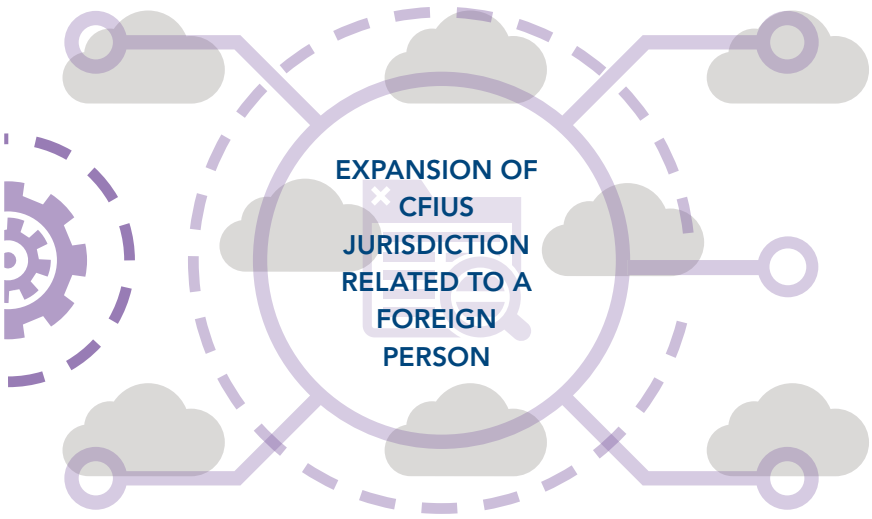
An Exception for Certain Investment Funds

FIRRMA contains a special exception for indirect investments by a foreign person held through an investment fund. Under FIRRMA, membership of a foreign person as a limited partner or an equivalent on an advisory board or a committee of an investment fund investing in critical technology, critical infrastructure or sensitive personal data would not trigger CFIUS jurisdiction if:

i. The fund is managed exclusively by a general partner or an equivalent;
ii. The general partner or an equivalent is not a foreign person;
iii. The advisory board or committee does not have the power to approve, disapprove or otherwise control investment decisions of the fund or decisions made by the general partner or an equivalent relating to investment held by the fund; and
iv. The foreign person does not otherwise have any power to control the fund.

Balancing Interests — Investment and Innovation

As FIRRMA moved through the legislative process special efforts were made to balance the US government's interest in encouraging foreign investment with efforts to enhance protection against the shifting nature of national security risks. Accordingly, FIRRMA limits CFIUS jurisdiction to transactions that



Transactions related to critical technologies, critical infrastructure, or a US citizen's sensitive personal data

Real estate transactions related to property in close proximity to a major port/airport or near a military installation

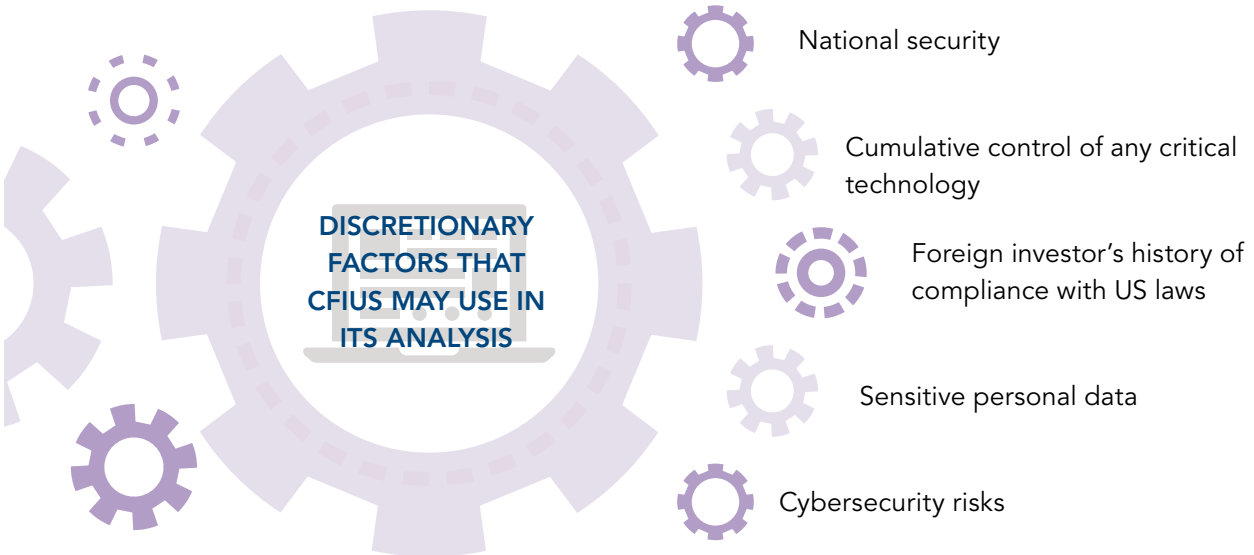
Foreign control of a covered US business (existed pre-FIRRMA)

pose a threat to US national security via an investment in a US business or US real estate. An expanded scope (e.g., the transfer of technology outside the US where there is no investment in a US business) would have begun to overlap with the US export control system (specifically as it relates to dual-use technology), making it more difficult for innovators based in the US to raise funding and move forward with research. A CFIUS scope broadened in this way would have incentivized research and development outside of the United States, potentially harming the US security interests that CFIUS was designed to protect. In some ways, FIRRMA is narrower in scope than analysts had previously predicted based on earlier drafts of the law. Under the final version of FIRRMA, CFIUS has not been granted the authority to review outbound transfers of intellectual property or technology unconnected to an investment in a US business.

Competition and Security — Special Concerns

In a section of FIRRMA titled "Sense of Congress on Consideration of Covered Transactions" CFIUS is allowed to consider in its analysis whether a covered transaction involves a ***country of special concern***. While earlier versions of proposed legislation specifically identified certain countries (including China, Russia, Iran and North Korea), FIRRMA does not identify such countries by name but suggests that these are countries that have demonstrated or declared strategies of acquiring critical technology or critical infrastructure that would affect US leadership in areas related to national security. The same section of FIRRMA lays out additional factors which may be taken into account in considering national security risks. These factors include:

- The cumulative effect or pattern of transactions by a foreign government or foreign person;
- The foreign person's record of complying with US laws and regulations;
- The impact on the capability and capacity of United States to meet national security demands, in particular the availability of human resources which may be critical to national security know-how; and
- Issues relating to sensitive personal data (such as personally identifiable information) or cybersecurity vulnerabilities.



A Focus on China?

Interestingly, FIRRMA requires the US Secretary of Commerce to prepare and submit to CFIUS a detailed report specifically on Chinese investment in the United States every two years.

Prior to 2016, China-related CFIUS transactions outnumbered those of all other countries combined both in terms of the number of transactions reviewed by the committee and the number of transactions blocked or postponed. Both President Trump and his predecessor President Obama have taken high profile actions to deny proposed US investments by Chinese companies. Some recent examples include the December 2016 denial of Fujian Grand Chip Investment Fund's acquisition of German semiconductor technology company Aixtron, the January 2018 non-approval of a proposed Chinese purchase of financial services and technology company, MoneyGram, and the more recent March 2018 blocking of Broadcom's attempted purchase of Qualcomm. In another example of US regulatory involvement with China-related transactions, from April to July of 2018, the US Department of Commerce banned American companies from selling components to Chinese mobile technology manufacturer ZTE as a result of reports of ZTE working around sanctions relating to Iran and North Korea. More recently, in October 2018 CFIUS did not approve the Japanese building supplies maker Lixil Group's attempt to sell its Italian subsidiary, Permasteelisa, to a Chinese construction group, Grandland Holdings. These actions demonstrate a heightened level of scrutiny for Chinese investments that reaches across political aisles, as well as an ever-widening justification for a deal to be denied or delayed by CFIUS.

This China-specific concern with regard to CFIUS transactions is neither new nor surprising and reflects a state of affairs that has impacted China and other Asia outbound investment activity for some time. According to data from Mergermarket, Chinese investments in the US plummeted 92 percent in the first nine months of 2018 compared to their peak in 2016. An overarching concern of US policymakers is that even modest technology transfers to China, especially in key fields such as artificial intelligence, quantum computing and semiconductors, may contribute to an evaporating US lead in technological breakthroughs, thereby posing a threat to US national security.

Process Reforms — Mandatory Filings and Procedural Adjustments

FIRRMA has introduced a new, abbreviated filing option referred to as a "declaration". A declaration may be submitted instead of the complete joint voluntary notice that was required prior to FIRRMA. It is an abbreviated notification, limited to five pages in length, the exact contents of which are not yet specified by FIRRMA and are to be set out by CFIUS under a future regulatory rulemaking process. Not later than 30 days after receiving a declaration, CFIUS must take one of the following actions:

- Request that the transactional parties file the more extensive joint voluntary notice;
- Initiate a unilateral CFIUS review of the transaction;
- Inform the parties that CFIUS is unable to take action based on the abbreviated declaration and that the parties may file the more extensive joint voluntary notice and request notification from CFIUS that it has completed its review; or
- Inform the parties that CFIUS has completed its review.

Under FIRRMA, mandatory filings with CFIUS will be required for certain transactions. This requirement will cover any investment by a foreign person in which a foreign government has, directly or indirectly, a substantial interest, which results in the foreign person acquiring, directly or indirectly, a substantial interest in a US business. FIRRMA requires CFIUS to define what constitutes a "substantial interest," but FIRRMA does establish two statutory exceptions of investments that are not to be considered substantial interests:

- Investments below a 10 percent voting interest; and
- Certain interests held as a limited partner through an investment fund (as described more fully above).

FIRRMA has also authorized CFIUS to require mandatory filings for other investments and transactions involving US businesses if they relate to critical technology. Indeed, CFIUS recently proposed that, effective November 10, 2018, parties to non-passive investments (both controlling and non-controlling) will be required to notify CFIUS of such transactions. (See further the inset box "Pilot Programs" below.)

Additionally, under FIRRMA, the CFIUS review period has been extended from 30 to 45 days. After the review period, FIRRMA provides for a 45 day investigation period, but CFIUS will be able to extend that investigation period by a further 15 days in "extraordinary circumstances". These changes become effective for any review or investigation initiated on or after the date of FIRRMA's enactment into law.

Importantly, for foreign investors, FIRRMA also now requires more transparency and accountability from CFIUS during the process in the form of mandatory comments or official acceptance of a draft or formal filing within ten business days of the submission of such filing. This is in contrast to the CFIUS process prior to FIRRMA in which transaction parties could see multiple week wait times for draft comments or acknowledgement of acceptance.

Under FIRRMA, CFIUS has the discretionary authority to require an administration fee in an amount not to exceed the lesser of 1 percent of the transaction value or US$300,000 (to be annually adjusted for inflation).

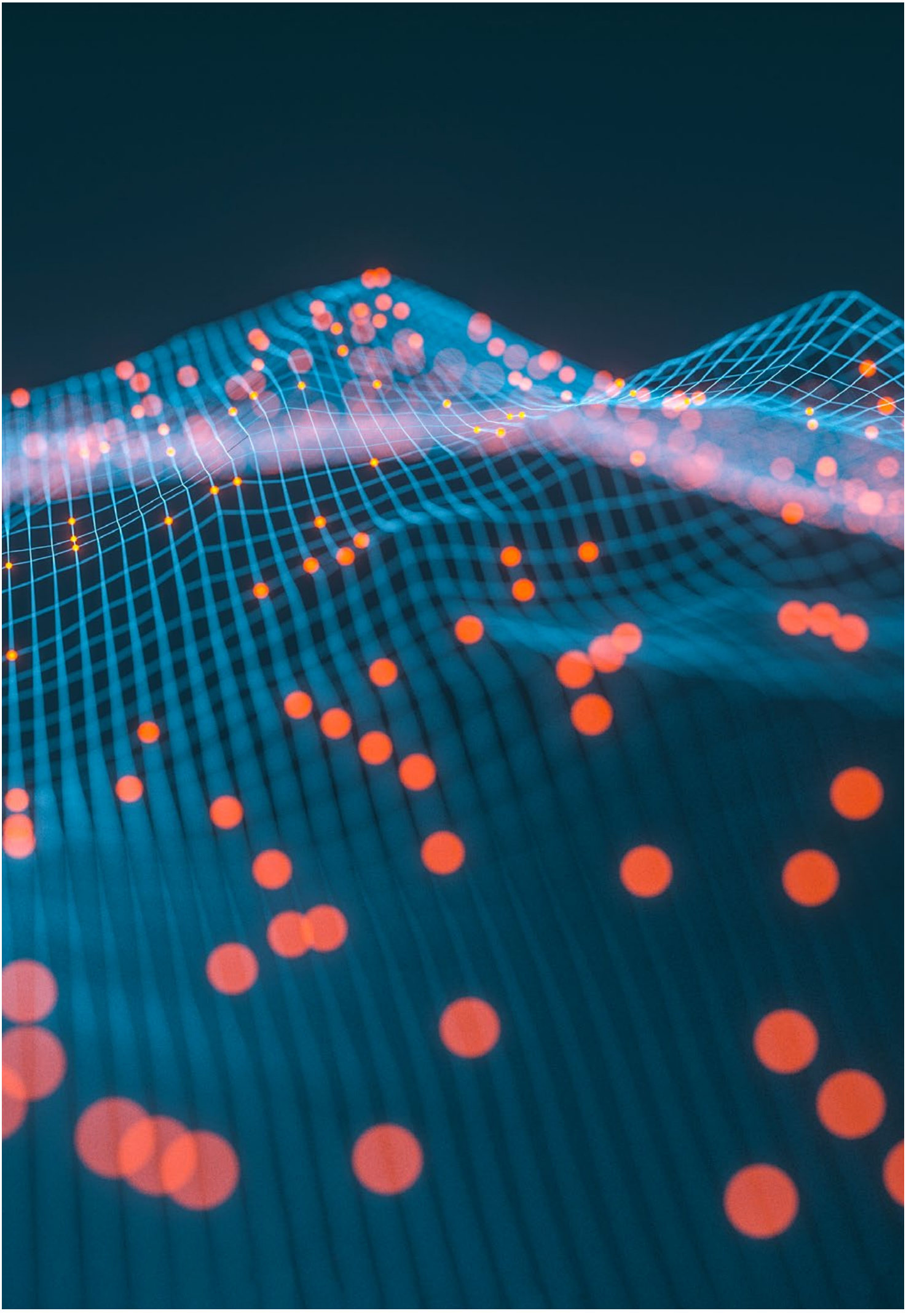
Most of the FIRRMA updates to CFIUS do not take effect immediately, but will become effective on the earlier of 18 months after the date of FIRRMA's enactment (13 August 2018) or 30 days after a public determination by the CFIUS chairperson that the required regulations, structure and resources necessary to implement the new regulations are in place.

Pilot Programs

FIRRMA provides CFIUS with temporary authority to implement one or more "pilot programs" that would otherwise require specific regulations to execute in this regard. On October 10, 2018, the US Department of Treasury, on behalf of CFIUS, introduced regulations governing the first FIRRMA pilot program. The pilot program:

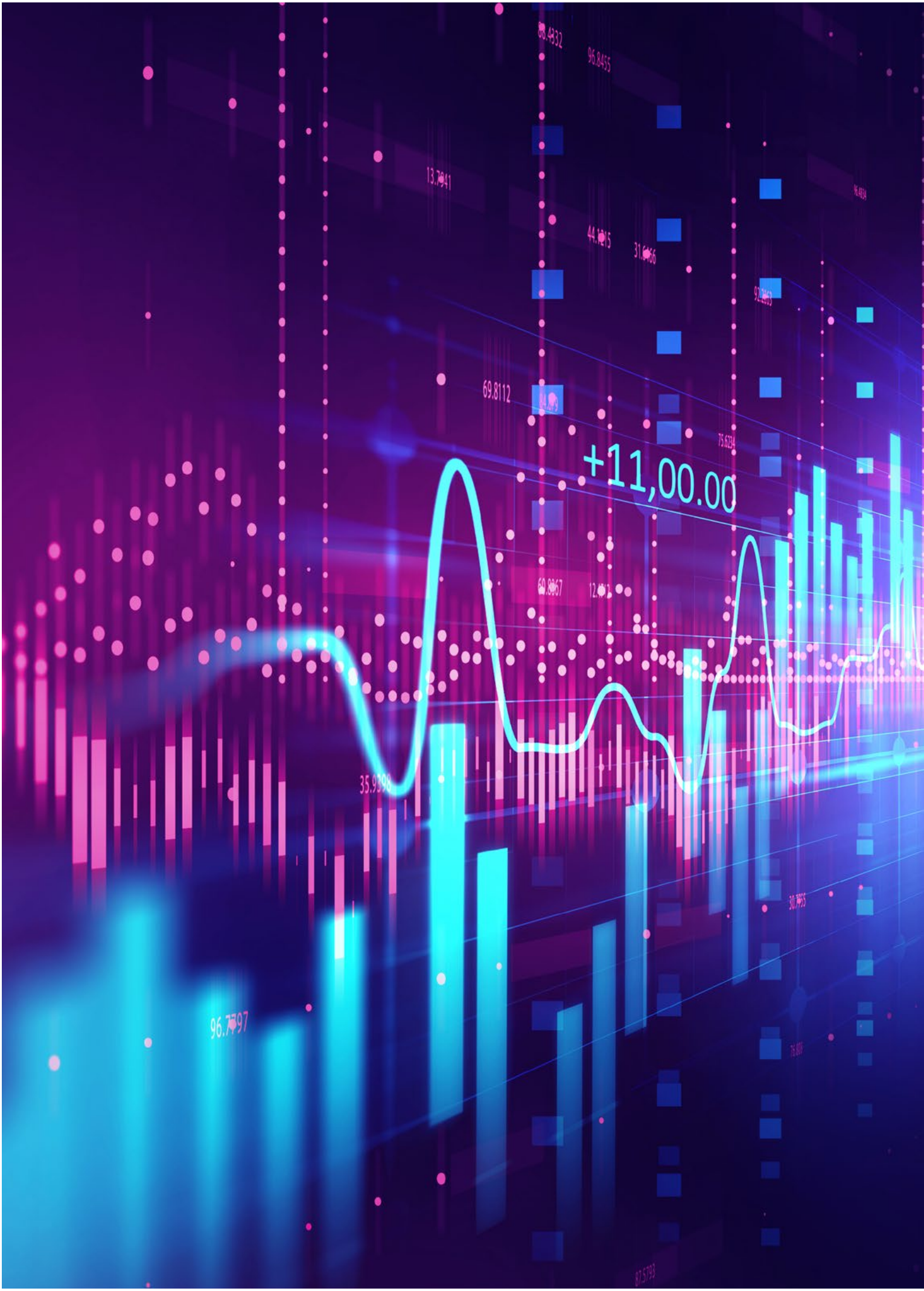
- Expands CFIUS jurisdiction to include certain non-controlling investments (consistent with FIRRMA as described above) made by foreign persons in US businesses involved in critical technologies (including emerging and foundational technologies) in certain identified industries;
- Covers 27 industries for which the US government believes a strategically motivated foreign investment could pose a threat to US technological superiority and national security including industries that have not previously been the focus of CFIUS such as research and development in biotechnology;
- Establishes mandatory declarations for foreign transactions involving these US businesses that are within the purview of CFIUS (i.e., both controlling and non-controlling investments);
- Covers all foreign persons and is not specific to any particular country; and
- Grants CFIUS the ability to assess any person who fails to comply with the new rules with a civil penalty up to the value of the transaction.

Early introduction of this pilot program gives CFIUS the opportunity to implement some of the changes prescribed by FIRRMA while providing the flexibility to make adjustments before the final rules have crystallized. The pilot program will commence on November 10, 2018 and end no later than March 5, 2020.



What Now? Impact Assessment, Mitigation Strategies and Beyond

- Parties considering cross-border transactions or investments in which a foreign person proposes to acquire interests in a US business should be familiar with the CFIUS process as modified by FIRRMA. In particular, if such a transaction involves any of the aforementioned critical or emerging and foundational technologies, we recommend undertaking a thorough assessment and submitting the proposed transaction for CFIUS review. Also, as CFIUS jurisdiction now covers certain non-controlling investments in a US business, investors should be aware that this may allow CFIUS to assert jurisdiction over smaller transactions and investments that historically had not been subject to such regulatory scrutiny.
- As the application of critical technologies and the demand for data cut across more and varied industries, it is possible that CFIUS' jurisdiction could spread to transactions that might, on the surface, seem outside of its mandate. For example, as FIRRMA considers any transaction that involves potential foreign ownership, control or collection of sensitive personal data to be a covered transaction, businesses in a number of consumer related sectors could be implicated: insurance products, healthcare, e-commerce, etc. Transaction participants should be creative when assessing whether a particular company uses technology or personal data in a way that may be caught by FIRRMA.
- Now that legislation has been enacted, some stability should begin to return to the market as there is a degree of certainty that flows from FIRRMA. FIRRMA should serve to promote a focus on those transactions that pose more defined risk to US national security interests. The last couple of years have generated much regulatory uncertainty, and uncertainty does not promote a strong cross-border M&A market. In this context, it is not surprising that, during a period of little visibility as to what the new FIRRMA rules might look like, inbound Chinese deals with American companies declined by 56 percent in 2017 with a continued decline through the third quarter of 2018. While many factors have caused deal making to drop-off, the regulatory uncertainty around CFIUS and FIRRMA contributed to this decline. We are cautiously optimistic that the enactment of FIRRMA will remove some of the regulatory overhang in the market.
- In addition, in June 2018, President Trump announced that he would not enforce new investment restrictions against China under Section 301 of the Trade Act of 1974, removing a longstanding cloud of doubt dampening the US-China M&A market. Had he decided to enact new restrictions, they were expected to target a number of key technology sectors, including information technology, aerospace, pharmaceuticals, alternative energy vehicles and robotics. This further clarity in the market should allow investors to gain a degree of confidence in the predictability of the regulatory hurdles in the US-China M&A process.
- All is not certain though, as a number of critical regulations still need to be developed and enacted. The pilot programs referred to above will inform CFIUS in its efforts to fully implement FIRRMA. If these programs are used to introduce additional challenges and hurdles for investors to navigate, a further chilling effect on international M&A transactions across multiple industries could arise.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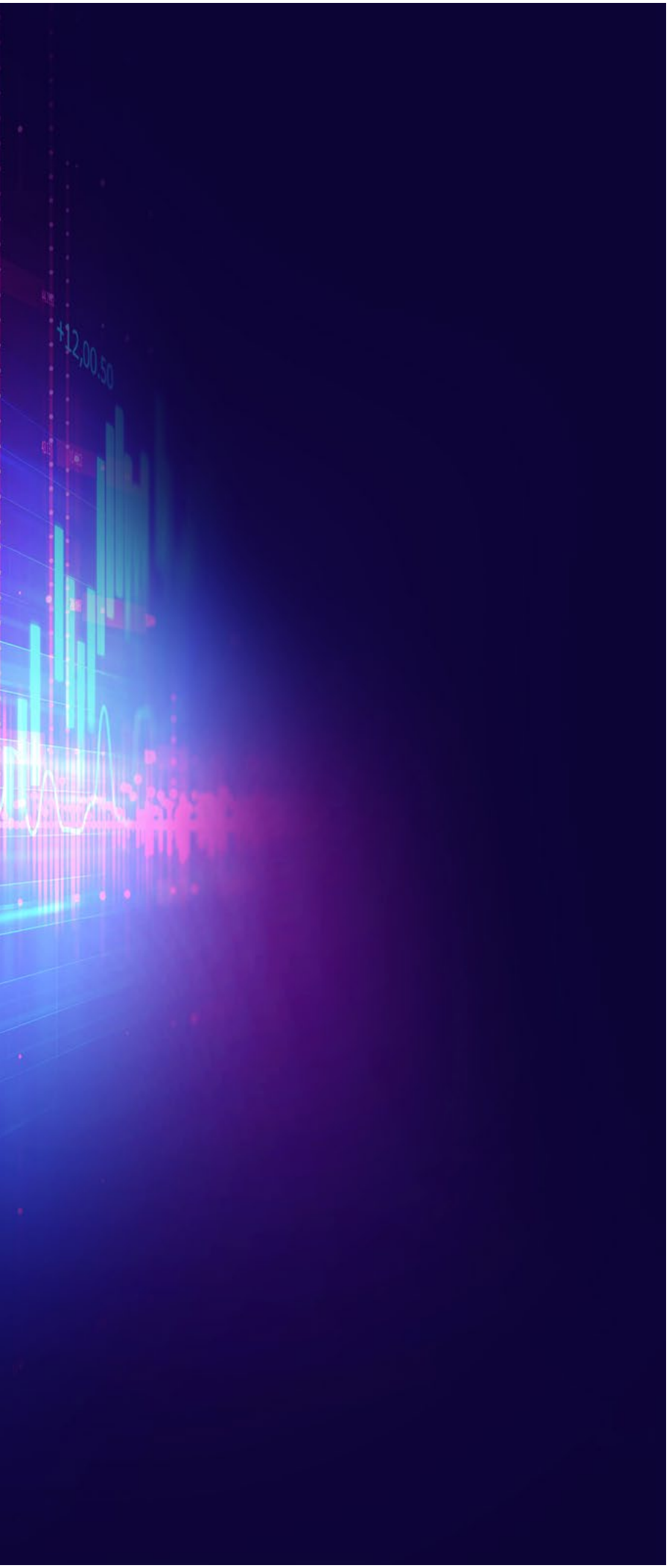

Investors should recognize that CFIUS and FIRRMA are one element of an evolving global regulatory, political and economic landscape that could impact transactions. Investors should remain mindful of regulatory developments and shifting attitudes toward foreign investment in other jurisdictions as well as the progression of international trade disputes, particularly between the US and China, and monitor their progress and potential impact on cross-border M&A transaction marketability and outcomes.