

International Trade & Finance

ADVISORY

November 16, 2008

New CFIUS Regulations

CLIENT MEMORANDUM

To: Clients and Friends

From: Covington & Burling CFIUS Team

Re: Final CFIUS Regulations

Executive Summary

Further to our earlier correspondence, this memorandum provides an overview of the final regulations published by the U.S. Department of Treasury ("Treasury") on November 14, 2008, governing the national security review of foreign investments conducted by the Committee on Foreign Investment in the United States ("CFIUS" or "Committee"). The final regulations formally implement the Foreign Investment and National Security Act of 2007 ("FINSA"), which amended section 721 of the Defense Production Act of 1950, 50 U.S.C. App. 2170 et seq. The final regulations will become effective 30 days after their publication in the U.S. Federal Register, which is expected to occur within the next several days.¹ In connection with the final regulations and as required by FINSA, Treasury also will be publishing guidance — possibly as early as this week — on the types of transactions that CFIUS has reviewed previously and that have presented national security considerations.

The final regulations largely adhere to the proposed regulations that Treasury issued last April and for which various comments were submitted in June. Like the proposed regulations, the final regulations reflect a balance of the various CFIUS agencies' interests and provide flexibility for CFIUS to review transactions that are likely to raise real or perceived national security risks, while also maintaining a process that is narrowly focused on national security and consistent with an overall policy of promoting foreign investment. As described further below, among the key aspects of the final regulations are:

- ***Additional clarifications on control for jurisdictional purposes.*** The final regulations maintain the broad and flexible definition of what comprises "control" by a foreign person that was set forth in the proposed regulations. However, the final regulations also include additional clarifying examples of transactions and structures that do and do not give rise to control, provide for additional minority shareholder protections that do not give rise to control, and emphasize that influence will not be considered to comprise control.

¹ With respect to transactions that arise between now and the effective date, CFIUS will continue to analyze such transactions for jurisdictional purposes under the existing regulations, even if the notice to CFIUS occurs after the effective date.

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- ***More extensive information requirements.*** The final regulations generally retain the proposed regulations' more extensive list of information that CFIUS will now require from parties. For many transactions, this more extensive list will likely reflect only a modest increase in the filing burden. While the list requires nearly double the amount of information formally requested under the prior regulations, a number of the additional items will not be relevant to most U.S. parties and foreign acquirors or will be relatively easy to answer. The burden will be greater in a minority of transactions, including those involving significant sales to U.S. defense and homeland security agencies and those involving large U.S. businesses with diverse product groups sold through extensive third-party channels.
- ***Maintenance of process-related points.*** The final regulations generally adhere to the process requirements that were contained in the proposed regulations last April. The two process points of greatest note are: (1) the final regulations continue to encourage, but do not require, parties to engage in pre-filing consultations with CFIUS; and (2) the final regulations impose a requirement on parties to respond to additional information requests from CFIUS within three business days (an increase from two business days in the proposed regulations).
- ***Civil penalties.*** The final regulations implement the proposed civil penalty provisions, which provide for the Committee to penalize parties up to \$250,000 for certain extraordinary violations and to negotiate liquidated damages provisions in agreements reached with CFIUS to mitigate the effect of the foreign investment on U.S. national security.

Overall, while there are instances in which the final regulations could have provided greater clarity from an investor perspective, the regulations faithfully adhere to FINSA and, together with FINSA and the implementing Executive Order from January, represent a net plus for the regulatory and political environment for foreign investment in the United States. The regulations themselves are more detailed and provide greater transparency than the prior regulations on CFIUS's considerations and what transactions may be covered by FINSA. Together with the Executive Order, the final regulations also set forth a more defined CFIUS review process and set a higher standard for when mitigation commitments may be negotiated with foreign investors. As with any revised regulatory regime, there remain certain mechanics and fine tuning to be worked out in the CFIUS review process, and we expect that to occur naturally over the next 12 to 18 months as the new Administration settles in. In the interim, we believe the vast majority of transactions should be unaffected by the regulatory transition and will continue to proceed smoothly through the CFIUS process.

Further detail on the key issues addressed by the final regulations is provided below.

Discussion of Specific Topics

1. Control. The final regulations did not change the definition of "control" — which is a predicate for CFIUS jurisdiction — as proposed in April. In issuing the final regulations, CFIUS has continued to emphasize that the definition of "control" "eschews bright lines" and, instead, remains a functional definition that must be applied on a case-by-case basis. The definition is: "the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of 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." The definition and accompanying preamble to the regulations also include a number of additional clarifications, such as:

- The final regulations retain the enumerated list of ten exemplary factors that may be considered “important matters” affecting an entity that was proposed last April. These include the power to cause extraordinary corporate actions such as the sale of all assets or dissolution of the entity as well as other “matters,” including approval over major expenditures, closing or relocation of facilities, the appointment or dismissal of managers and officers (not just a negative right on management), and how non-public information is treated.
- The amount of share interests and the right to board seats held by a foreign entity are highly relevant to finding control, but they are not necessarily determinative. Rather, CFIUS will take into consideration all relevant factors of a foreign person’s ability to determine, direct, or decide important matters affecting a U.S. business.
- The final regulations continue to state that ten percent is not a bright-line for control purposes. A foreign entity can hold less than 10 percent of voting interest and still have control if other indicia of control are present. However, if the entity holds less than 10 percent “solely for the purpose of passive investment” (emphasis added in the final regulations), the transaction, as under the old regime, will not be subject to CFIUS jurisdiction. It also remains possible for an investor to hold more than a 10 percent stake and likewise be deemed non-controlling so long as the ownership stake is demonstrably passive or there are no indicia of control.
- For foreign government-related transactions — which presumptively require a second-stage investigation or higher-level sign-off for conclusion without investigation — the definition of “control” is relevant both to determine whether the foreign entity is controlled by a foreign government and, in turn, whether the transaction would present control of a U.S. business.²
- The preamble to the regulations emphasizes that the “control” definition is squarely focused on actual control, not mere influence. In this regard, the examples make clear that commanding a single board seat or exercising *pro rata* voting rights do not necessarily constitute control.

2. Minority Protections. The final regulations have expanded the list of minority shareholder protections that do not confer control to include the power to prevent the voluntary filing of bankruptcy or liquidation, and the power to prevent the change of existing legal rights or preferences of a particular class of stock held by minority investors. Treasury also reiterated that the list of minority protections contained in the final regulations is not exclusive and that other negative rights may exist to protect investment-backed expectations without conferring control on the minority shareholder. CFIUS will consider whether such other rights may exist without conferring control on a case-by-case basis. In this regard, the preamble to the final regulations expressly states that CFIUS will consider favorably the parties’ opinion that the following additional minority shareholder protections do not in themselves confer control:

- the power to prevent changes in the capital structure of the entity, including through mergers, consolidations, or reorganizations, that would dilute or otherwise impair existing shareholder rights;
- the power to prevent the acquisition or disposition of assets material to the business outside the ordinary course of business;

² On the issue of foreign government transactions, the forthcoming guidance to be issued by Treasury in connection with the regulations “clarifies that whether a foreign government-controlled entity operates on a purely commercial and market-driven basis is among the important factors that [CFIUS] takes into consideration when assessing whether foreign government control in a particular transaction poses concerns about possible impairment of U.S. national security.”

- the power to prevent fundamental changes in the business or operational strategy of the entity;
- the power to prevent incursion of substantial indebtedness outside the ordinary course of business;
- the power to prevent fundamental changes to the entity's regulatory, tax, or liability status; and
- the power to prevent any amendment of the Articles of Incorporation, constituent agreement, or other organizational documents of an entity.

3. U.S. Business. The final regulations repeat that “covered transactions” encompass businesses in the United States only to the extent of their activities in interstate commerce in the United States. In addition, the final regulations adopt the proposed regulatory focus on “U.S. businesses” rather than “U.S. persons” to make clear that controlling investments in an entity not organized as a separate legal entity may still be subject to CFIUS review. Thus, for example, the sale of a business unit or assets in the United States that includes customer lists, intellectual property, and employees (i.e., elements of a going concern) would be a covered transaction.³

4. Foreign Person/Foreign Entity. The final regulations maintain the definition of “foreign person” reflected in the proposed regulations. For CFIUS purposes, a foreign person is any foreign national, foreign government, or foreign entity or any entity over which a foreign national, foreign government or foreign entity exercises control. The nuance in this definition relates to “foreign entity,” and the final regulations modified the definition of that term. “Foreign entity” now means any entity “organized under the laws of a foreign state if either its principal place of business is outside the United States or its equity securities are primarily traded on one or more foreign exchanges,” provided however that if U.S. nationals own more than 50 percent of the entity, it will not be considered a foreign entity.

5. Lending Transactions. Loans historically have not been considered transactions subject to CFIUS review unless they were equity and governance interests masquerading as lending transactions. The final regulations maintain this historical approach, with some clarifying modifications in the regulatory language. The final rules clearly establish that ordinary lending transactions are not covered transactions, even if they are secured by the paper or assets of the U.S. business. The regulations carve out exceptions for lending transactions that are executed under the cloud of imminent default and for transactions through which the foreign party obtains economic or governance rights characteristic of an equity investment. Additionally, for lending transactions executed under the cloud of imminent default, the regulations provide for special treatment of foreign persons who make loans in the ordinary course of business. For this group, consistent with its historical approach and regulations, CFIUS will take into account whether the foreign person has made any arrangements to transfer management decisions over the U.S. business to U.S. nationals for purposes of analyzing whether the loan is a covered transaction. The final regulations also provide special exceptions for banking syndicates in which foreign lenders play a non-controlling role.

6. Convertible Voting Instruments. The regulations governing convertible instruments have been redrafted, but they maintain the general approach of the proposed rules. When a transaction involves the acquisition of convertible instruments, CFIUS will apply a factor-based analysis to determine whether to include the rights associated with those convertible instruments as part of the assessment of whether the transaction is a covered transaction. These factors include the imminence of the conversion, whether the conversion depends on factors within the control of the acquiring party, and whether the

³ With respect to what transactions are covered by FINSA, it is worth noting that the final regulations continue to maintain the historical exception for “Greenfield” investments. Such investments are not covered transactions within the scope of FINSA.

rights that would be acquired upon conversion can be reasonably determined at the time of the acquisition. Even if CFIUS determines not to consider the rights associated with convertible instruments as part of its analysis at the time of acquisition, any eventual conversion could separately constitute a covered transaction, depending on the rights conferred by the convertible instruments.

7. Incremental Acquisitions. The final regulations explain CFIUS's approach for evaluating whether incremental acquisitions may be covered transactions. If a foreign person acquires an additional interest in a U.S. business, the question whether that incremental acquisition is a covered transaction depends on the CFIUS outcome of the initial acquisition. If CFIUS determined that the initial acquisition was a covered transaction and that it was nevertheless permissible because it did not threaten to impair the national security, then an additional acquisition in the U.S. business by the same foreign person is not a covered transaction. However, if CFIUS determined that the initial acquisition was not a covered transaction, or if the incremental acquisition involves a different foreign person, then the incremental acquisition may be a covered transaction.

8. Critical Infrastructure. The final regulations largely adopt the definition of "critical infrastructure" that was proposed in April. The regulations define "critical infrastructure" to mean "in the context of a particular covered transaction, a system or asset, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system or asset of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security." (emphasis added) The underlined language has been added to the statutory definition. These changes were intended to clarify that what matters from CFIUS's perspective is not necessarily the asset class at issue in a transaction, but rather the specific character of the actual underlying asset or assets. CFIUS "will not deem classes of systems or assets to be, or not to be, critical infrastructure." Thus, for example, the simple fact that a transaction might involve foreign control over any given U.S. port does not necessarily mean it involves "critical infrastructure" for CFIUS's purposes; rather, what matters are the actual port assets that are at issue in a particular transaction.

9. Information Requirements. As noted, the final regulations generally retain the proposed regulations' more extensive list of information that CFIUS will now require from parties. In total, the additional information requests nearly double the number of questions posed by CFIUS that must be addressed in a formal notice filed with the Committee. As we explained in our April alert regarding the proposed regulations, this broader universe of information requests simply seeks information that was previously requested only on a case-by-case basis and in certain types of transactions. For example:

- There are additional questions relevant to defense transactions that parties would not previously have been required to address in the context of non-defense transactions, including questions on whether the government contracts implicated in the transaction are for sole-source or single qualified source products or are priority-rated contracts. Now such questions potentially will require a response in every filing, even if only to say "not applicable."
- In certain technology transactions, it has been common for CFIUS to inquire as to the cyber security practices of the U.S. business. Under the new regulations, every notice to CFIUS must address whether a cyber security plan exists with respect to protecting the U.S. business.
- The final regulations include a specific requirement to provide the U.S. market share for product and service categories of the U.S. business and the methodology to determine the market share. In prior cases, CFIUS commonly, but not always, asked for relative market shares of the U.S. business.

- The U.S. business must provide information on products that are supplied to third parties and rebranded, including the names of the other brands. This rebranding question typically has come up only in select cases, when CFIUS had particular concerns about the foreign acquirer and when the transaction involved components or products that were combined with other products that were sold to the U.S. government.
- In addition to supplying certain “personal identifier information” for Board members and senior officers of the acquiring foreign person, the final regulations require such persons to produce a curriculum vitae or other similar professional synopsis and include a category for military service, which has not been requested in all cases previously.

The final regulations do contain one important clarification, however, that narrows the scope of the information requests: Under the proposed regulations, parties would have been required to identify every contract in effect within the past three years with *any* U.S. government agency. The final regulations take a more sensible approach, requiring information only for those contracts in effect within the past three years with a U.S. government agency with national defense, homeland security, or other national security responsibilities. Treasury also has indicated that it will consider waiver requests for informational items in extraordinary cases where parties can demonstrate that responding to the particular item would be unduly burdensome.

10. Process Matters. The final regulations essentially implement the process-related matters that were set forth in the proposed regulations. Consistent with the proposed regulations, the final regulations encourage, but do not require, parties to engage in a pre-consultation process with CFIUS prior to formally notifying the Committee of a transaction. The regulations state that such pre-filing, to the extent it occurs, should take place at least five business days prior to a formal filing. The guidance to be published in the Federal Register will include a discussion of certain types of cases for which CFIUS considers it useful for parties to provide notice in advance. In our experience, it is most helpful to provide pre-filings when the transaction presents complicated jurisdictional issues, clearly implicates significant U.S. national security interests, or is likely to attract political interest.

The final regulations also set a deadline for transaction parties to respond to information requests from CFIUS. During a review, transaction parties must respond to information requests from CFIUS within three business days (the proposed regulations would have set the deadline at two business days) or otherwise seek an extension of the timeframe for responding to the information requests. If parties fail to respond to such information requests within three business days, they risk having CFIUS reject the entire notice, effectively restarting the statutory clock (and even then, only after the requested information has been provided).

11. Safe Harbor. The final regulations, along with the Executive Order from last January, preserve the safe harbor for transactions that have been reviewed by CFIUS or decided by the President. Once CFIUS has reviewed a transaction and provided written notice to the parties that the review is completed (either because CFIUS determines that the transaction is not covered or because the transaction does not threaten to imperil the national security), this safe harbor may only be overcome for a limited set of extraordinary reasons detailed by statute. Specifically, CFIUS may reopen the review of a transaction if the parties submitted false or misleading material information to CFIUS, omitted material information, or materially breached a mitigation agreement.

12. Civil Penalties. As noted, the final regulations formalize the prospect of civil penalties that could be applied through the CFIUS process. Specifically, after the effective date of the regulations, CFIUS can impose a civil fine up to \$250,000 per violation against any person who, intentionally or through gross negligence, submits a material misstatement or omission in a notice or makes a false certification to CFIUS. CFIUS likewise can impose a fine up to \$250,000 or the value of the transaction, whichever is

greater, against a person who, intentionally or through gross negligence, violates a material provision of a mitigation agreement. Civil penalties imposed for violations of mitigation agreements are separate and apart from any damages provisions in the mitigation agreements themselves. Moreover, the penalty provisions apply after the effective date regardless of when the transaction occurred or when the mitigation agreement was signed. In this regard, the preamble to the regulations use the example of an intentional violation after the effective date of a mitigation agreement signed in 2000, noting that the party committing the violation would be subject to the civil penalty rules. The final regulations also permit CFIUS to negotiate for liquidated damages provisions in mitigation agreements entered into after the effective date.

The regulations effectively require CFIUS as a whole, rather than individual agencies, to make the determination to issue fines. Parties who receive written notice of a penalty under the regulations will have 15 days to appeal to the Treasury Department. The full Committee then will have 15 days to respond to the appeal. Penalties issued by CFIUS will be enforceable in a civil action brought in U.S. federal district court.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our international trade & finance group:

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