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CFIUS Report Underscores Growing Chinese Investment In US

Law360, New York (February 25, 2016, 5:26 PM ET) --

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The Committee on Foreign Investment in the United States (CFIUS) released its annual report to Congress on Friday regarding foreign acquisitions of U.S. businesses reviewed by the CFIUS in 2014. The report provides important data that underscores the continued shift in the makeup of foreign direct investment into the United States, driven largely by a surge in Chinese investment, and offers an opportunity to reflect on several trends in the CFIUS process:

- First, while Chinese transactions accounted for less than 20 percent of all matters reviewed by CFIUS from 2012 to 2014, the overall number is growing and at any given moment, there likely will be one or more complex Chinese transactions under review by CFIUS. These matters have a tendency to dominate the system and, consequently, can have collateral impacts for other transactions submitted to CFIUS at or around the same time.

- Second, Chinese transactions in certain areas, such as semiconductors and other high-technology manufacturing processes, are reaching a volume that is attracting greater attention within CFIUS with a view not only as to the individual transactions, but also with respect to the broader impact on particular sectors in the United States.

- Third, the foregoing suggests a mixed outlook for Chinese investments: on the one hand, there have been — and will continue to be — ever more complex cases that present challenging national security considerations to resolve; at the same time, a significant majority of Chinese transactions do not present unresolvable national security concerns and have been, and will continue to be, approved.

- Fourth and finally, as an overall matter, the committee has been productively (and commendably) focused on shortening its review periods for most transactions, regardless of the country of origin, with the result that the 2014 annual report — and more recent experience — reflects more cases being approved in the first 30-day review period.

Chinese Transactions Continue to Dominate

For the third year in a row, Chinese acquirers filed the greatest number of notices subject to CFIUS jurisdiction. Of the 147 notices that CFIUS reviewed in 2014, a total of 24, or 16.3 percent, were from China. While there was a small decrease in the proportion of total notices attributed to Chinese acquisitions in 2014 compared with the two prior years — 23 notices in 2012, or 20.2 percent of the total, and 21 notices in 2013, or 21.6 percent of the total — the overall volume of Chinese acquisitions unquestionably continues to dominate the CFIUS agenda. Thus, looking back at the three-year period from 2012 to 2014, Chinese transactions represented nearly 19 percent of all deals reviewed by CFIUS, more than 6 percentage points greater than the United Kingdom, the next largest home to filers. Canada and Japan occupied third and fourth place, respectively, in 2014, and similarly held top positions in the prior two years.

The report makes unmistakably clear that China has emerged as a key source of inbound investment in the United States. The increased maturity of the Chinese economy, coupled with slowing domestic demand, a greater desire by the Chinese government to diversify from its U.S. Treasury holdings and the attractiveness of the U.S. economy, are all key factors driving the growth in Chinese investment. These factors are unlikely to change meaningfully in the near term, with the result that CFIUS must be prepared to cope with a continued acceleration in Chinese investment over the next several years. Indeed, our experience is that the current year alone is off to a record start in terms of the volume of Chinese transactions, which have touched on a number of sectors and many of which are major international merger and acquisition matters with the U.S. being an important part of, but not the exclusive, scope. This increased M&A activity is a positive development, reflecting the continued attractiveness of the U.S. market to investment.

At the same time, the volume of Chinese matters may present an increasingly complex dynamic for CFIUS for a variety of reasons, including the prevalence of Chinese government ownership or other governmental influence over the acquirer; connections between the acquirer's senior management and the Chinese government; and financing or subsidies from the Chinese government. Additionally, Chinese acquirers unsurprisingly are attracted to transactions that involve technologies and capabilities essential to becoming a global player in key industries — and that consequently may involve U.S. critical infrastructure sectors and/or assets subject to U.S. export controls. Because of the complexities of these dynamics, in combination with the volume of transactions from China, there is a real question of whether CFIUS has the capacity to continue to manage its workload. At a minimum, Chinese matters have tended to — and we expect they will continue to — dominate the overall CFIUS process. In this regard, we are seeing a potential tipping point emerge with respect to the flexibility and capacity of the U.S. regulatory and political processes to absorb the growing flow of Chinese investment. We discuss the implications of this for Chinese investment further below.

The Impact of Chinese Transactions on Matters Withdrawn from CFIUS or Mitigated by CFIUS

The added complexity presented by Chinese investment may be reflected as well in the reported

numbers of matters withdrawn or abandoned following a review by CFIUS, and the number of matters in 2014 in which CFIUS entered into a mitigation agreement or some other condition (such as a letter of assurance) to address its national security concerns.

Increase in Withdrawn Notices and Abandoned Transactions

The data indicates that CFIUS is encountering a growing number of challenging cases in which the government's national security imperatives do not align with the parties' commercial needs and objectives. Thus, of the 147 notices reviewed by CFIUS in 2014, no fewer than 12 were reported withdrawn from consideration. Given that the report notes that only one of these transactions was re-filed for further review, this suggests that the remaining 11 transactions were abandoned by the parties. By comparison, eight notices were reported withdrawn and — implicitly — seven transactions were abandoned in 2013. (Additionally, the 2014 report notes that one notice was rejected during the review or investigation; a rejection is not a disapproval per se but rather typically is attributable to material changes or omissions in a filed notice.)

In our view, the rise in the number of transactions abandoned or rejected likely is due at least in part to the increase in the volume of Chinese acquisitions reviewed by CFIUS; at the same time, it is important to note that many other factors — such as changes in the financial markets or in the target company's performance — also may explain this trend.
Nevertheless, it is equally true — and most important — that the vast majority of cases before CFIUS, including cases involving Chinese parties, still are approved.

Mitigation Measures Applied to Fewer Transactions

The report indicates that a small but not immaterial number of transactions continue to be subject to legally binding mitigation. In 2014, nine cases (6 percent) resulted in mitigation, compared with 11 cases (11 percent) in 2013 and eight cases (7 percent) in 2012. The nine cases that were mitigated in 2014 arose in the software, services and technology industries. These numbers, taken together with the increase in withdrawn notices and abandoned transactions, suggest that there continue to be a meaningful number of circumstances in which there appears to be no clear path to resolve U.S. national security concerns (or no path that the parties deem commercially feasible such that the parties would agree to mitigation instead of abandoning the transaction). That said, as noted above, CFIUS and the transaction parties are able to find a resolution in most cases. The consequent implication for Chinese transactions is that the parties should (a) undertake more nuanced and careful planning before entering into transactions and (b) be prepared to respond and adjust as the CFIUS process takes shape.

Intelligence Community Continues to Believe There May Be a Coordinated Strategy to Acquire U.S. Critical-Technology Companies

In its 2014 report, CFIUS again noted that the U.S. Intelligence Community "believes there may be an effort among foreign governments or companies to acquire U.S. companies involved in research, development, or production of critical technologies for which the United States is a leading producer." This is the same assessment the committee reported in 2013 but is a departure from its 2012 report, when CFIUS noted that the Intelligence Community judged it "unlikely" that there is a coordinated foreign strategy to acquire U.S. critical-technology companies.

The 2014 report also matches the five prior annual CFIUS reports in noting the Intelligence Community's finding that foreign governments are "extremely likely" to continue using a range of collection methods

to obtain U.S. critical technologies.

One other significant trend in the most recent report relates to the particular critical technology sectors in which foreign investment is occurring in the United States. Thus, in 2014, the largest number of mergers and acquisitions in critical technology companies occurred in the information technology and electronics sectors. By contrast, in recent prior years the key critical-technology sectors in which foreign investment was focused were (a) machinery and equipment and/or (b) aerospace and defense.

Notably, in our experience, certain members of CFIUS also are increasingly focused on how transactions in the information technology sector can introduce risk into IT environments via the provision of services, not only equipment. In particular, this is true with respect to even Western-based service providers who are prevalent in the provision of IT services, including consulting services, to the U.S. federal government or companies in critical infrastructure sectors. This focus reflects a concern that foreign governments, unaffiliated with the home country of the investor, may find avenues to compromise U.S. government or critical infrastructure sectors through a compromise abroad of Western service providers.

Important Positive Trend: Reduction in Proportion of Cases Proceeding to Second-Stage Investigation

There is an important positive trend for all investors — not only Chinese — also embedded in the most recent annual report: the committee's efforts to clear transactions in the first 30 days has gained traction, and is reflected in the numbers reported in the 2014 annual report. Specifically, CFIUS reported that 52 of the 147 notices reviewed in 2014 — 35 percent of the total — proceeded to a second-stage investigation following the initial 30-day review period. This is a significant reduction from 2013, when close to half of all cases proceeded to investigation; it also is the lowest proportion of cases to proceed to investigation in the five-year period from 2010 to 2014. In our view, this statistic likely is due in significant part to a concerted effort by CFIUS to approve less complex cases to the extent possible in the initial 30-day review period in order to create capacity to focus on more challenging cases during the second-stage investigation. And while CFIUS does not identify by home country the percentage of reviews that move to a second-stage investigation, it almost certainly is the case that a disproportionate percentage of those reviews have involved Chinese acquirers.

Other CFIUS Report Highlights

- The total number of CFIUS notices increased by 50 percent in one year, from 97 in 2013 to 147 in 2014. While this still is lower than the record number of notices reviewed in 2008 (155 notices) — the year new regulations were promulgated by CFIUS to implement the Foreign Investment and National Security Act of 2007 and prior to the onset of the global recession — it is considerably higher than the number of notices filed in other recent years, including 2009 (65 notices), 2010 (93 notices), 2011 (111 notices) and 2012 (114 notices).

- Acquisitions from Asia (i.e., China, Hong Kong, India, Indonesia, Japan, Singapore, South Korea and Taiwan) declined slightly to 38 percent of all notices filed in 2014, from 47.4 percent of all notices filed in 2013. Nearly half of all notices from Asia came from China.

- European acquisitions (i.e., Finland, France, Germany, Ireland, Liechtenstein, Luxembourg, Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom) accounted for 40 percent of notices filed in 2014, compared with 28.8 percent in 2013.

- As in prior years, the largest concentration of acquisitions was in the manufacturing sector. Across all manufacturing subsectors, the largest numbers of acquisitions were in the following: computer and electronic products (29 notices); machinery (9 notices); transportation equipment (9 notices); and chemical (7 notices).

Implications for Chinese Investment in the United States

While isolated to a relatively small number of transactions even five years ago, Chinese investments have established an important and quickly growing beachhead in the United States and, in turn, before CFIUS. The volume of complex Chinese deals presents new challenges in processing cases quickly and likely is refocusing — at least indirectly — the committee's priorities in the near term. This dynamic will be further impacted by the fact that 2016 is a political election year and, consequently, by the risk that some transactions may be prone to becoming politicized.

The risk may be more acute in some sectors (such as semiconductors, where there has been a greater focus within the government and publicly on the opportunities and pressures for the industry from China), but it is not limited to a particular sector. Moreover, it is worth noting that there is a greater prospect that even nonsensitive sectors can become more politically sensitive. At the same time, given the sheer volume of transactions, some deals that previously would have attracted attention may benefit from being overshadowed, and thereby protected, by other transactions. These factors will create a more complex environment to navigate over the next 18 to 24 months, continuing through the lengthy nomination and confirmation process for senior leaders of the new administration. Consequently, parties will want to consider CFIUS dynamics at the earliest possible stages in a cross-border transaction, and will want to devote adequate time and attention both to national security due diligence and CFIUS planning well before entering into a transaction agreement.

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