COVINGTON

Forthcoming CFIUS Regulations: What Businesses Need to Watch

September 10, 2019

CFIUS

Introduction

The U.S. Department of the Treasury is expected to issue soon proposed regulations implementing the Foreign Investment Risk Review Modernization Act ("FIRRMA"), legislation enacted in August 2018 that reformed the Committee on Foreign Investment in the United States ("CFIUS" or the "Committee"). FIRRMA transformed CFIUS's authorities, but many of the most important issues were left for CFIUS to address through regulation. The new proposed regulations accordingly will carry broad implications for all parties involved in cross-border investment and M&A.

Our previous analysis of FIRRMA is available here, and our analysis of the pilot program on critical technologies (the "Pilot Program") that temporarily implemented certain of CFIUS's new authorities related to "critical technologies" is available here.

We expect that the regulations initially will be issued as a proposed rule, published in the Federal Register. Once the proposed regulations are published, there will be a short window — potentially as little as 30 days — in which the Treasury Department will accept formal, on-the-record comments. There likely will not be other opportunities to comment formally on the proposed regulations.

In anticipation of the proposed regulations, this alert provides an introduction to the significance of this critically-important rulemaking, together with an overview of the procedural aspects of the rulemaking and key issues that likely will be addressed. We will update our clients and friends when the proposed regulations are issued and will provide a further analysis at that time.

* * * *

1. **What is the FIRRMA rulemaking and why is it so important?**

The FIRRMA rulemaking formally implements the authorities provided to CFIUS under FIRRMA, which was the most significant reform of CFIUS in its 30+ year history. The rulemaking, in turn, is significant for three principal reasons.

First, the proposed rules will indicate how CFIUS intends to implement the expanded jurisdictional and procedural authorities that it received under FIRRMA. Specifically, FIRRMA expanded CFIUS jurisdiction to include certain non-controlling, non-passive transactions, as well as certain real estate transactions. The legislation also departed from the traditional CFIUS

voluntary filing regime by authorizing the Committee for the first time to require filings for certain transactions, and to impose substantial penalties for failing to comply with those requirements. FIRRMA also established a new short-form filing (the so-called "declaration") and a streamlined 30-day review process in connection with the newly-required submissions. To date, only certain of these authorities actually have been implemented by CFIUS, which it undertook to do through last November's Pilot Program regulation. The forthcoming proposed rules will provide the first look at how CFIUS now intends to implement and finalize the full array of its new powers.

Second, in addition to implementing FIRRMA's new authorities, the rulemaking provides an opportunity for CFIUS to revisit historical definitions central to its jurisdiction and authorities, such as the elastic and sometimes murky concepts of "control," "foreign person," and "U.S. business." We also expect that CFIUS will, through examples and explanatory comments stated in the preamble to the proposed regulations, describe how the national security considerations that inform its process have evolved since the Committee's last rulemaking over a decade ago.

Third, the regulations offer CFIUS an occasion — if it wishes — to revisit the Pilot Program on critical technologies, which is a temporary authority that will terminate when the final regulations take effect. There are a number of intriguing possibilities for refining or modification of the Pilot Program; simply by way of example, CFIUS could change the scope of investors to which the Pilot Program's mandatory filing requirements apply (currently all foreign persons) or it could modify the scope of U.S. businesses that are implicated.

2. What investors and industries should be paying attention?

Any parties involved in cross-border investment or M&A will have an interest in the forthcoming regulations. The proposed rules will affect directly both the extent to which the United States maintains its tradition of openness to foreign direct investment and the degree to which transaction parties can have confidence in the law and regulations governing such investment.

That said, certain industries and investors will have particular interest, including:

- **Investment Funds (including Private Equity and Venture Capital)**. Prior to FIRRMA, the U.S. private equity and venture capital communities had only occasional interactions with CFIUS because the Committee's jurisdiction was predicated on a foreign person acquiring "control" of a U.S. business through a transaction. Investments by foreign limited partners ("LPs") in investment funds rarely satisfied that standard, and in turn, CFIUS predominantly became relevant to U.S. private equity and venture capital firms when they were selling assets to foreign persons or when an acquisition by these firms included a large co-investment by foreign LPs. The largely voluntary nature of CFIUS review pre-FIRRMA also meant funds could exercise discretion in evaluating whether a given investment raised national security concerns and merited a filing. But with the Pilot Program mandating declarations for certain non-passive, non-controlling investments, there are now more questions about the extent to which the CFIUS process could apply to certain investment funds going forward.

  To be sure, Congress took steps in FIRRMA to avoid subjecting to CFIUS review passive investments by foreign persons as limited partners in U.S.-controlled and managed investment funds; thus, Congress adopted a "Specific Clarification" for investment funds, which sets out expressly the interests and rights that a foreign person may have in an investment fund without rendering the fund itself "foreign" or having foreign LPs' investments in portfolio companies subject to CFIUS jurisdiction. The

Specific Clarification, however, must be implemented though the forthcoming regulations before it becomes finally effective. Relatedly, in the rulemaking, CFIUS also may address:

  - The rights that LPs may have in a fund, either directly or through participation on an advisory committee, without (i) being deemed to control the fund or (ii) having indirect investments in U.S. portfolio companies be subject to CFIUS review;
  - The criteria under which foreign-incorporated funds — such as Cayman Islands-organized funds — may be exempted from the "foreign entity" definition and therefore not subject to CFIUS jurisdiction. In particular, the regulations may provide new definitions of "foreign entity" and/or "principal place of business," which are core to the jurisdictional analysis for funds; and
  - The level of equity interest that an LP may hold in an investment fund without being viewed as controlling the fund, and whether that interest is any different for state-owned investors than for non-state-owned investors.

- **Infrastructure-related industries, including energy, telecom, and transportation**. FIRRMA defines three classes of U.S. businesses that are subject to heightened scrutiny and expanded jurisdiction for CFIUS review, one of which is "critical infrastructure" companies. The category encompasses businesses that own, operate, manufacture, supply, or service U.S. critical infrastructure. Additionally, FIRRMA requires CFIUS to define a "subset of critical infrastructure that is likely to be of importance to the national security of the United States." How CFIUS chooses to explain what it means to manufacture, supply, and service critical infrastructure, as well as delimit which critical infrastructure is important for national security, will determine the scope of U.S. businesses that may be covered by this jurisdictional expansion, including mandatory filings for foreign investments with government ownership.
- **Technology and software, especially in such advanced technologies as artificial intelligence, semiconductors, quantum computing, advanced manufacturing, and similar 21st century technologies.** CFIUS already has implemented certain of its authorities under FIRRMA related to critical technologies through the Pilot Program. We now are watching to see whether CFIUS will alter the scope of the mandatory filing requirements established by the Pilot Program, either by narrowing the definition of "critical technologies" or the universe of foreign persons subject to the filing requirements.
- **Life Sciences**. FIRRMA codified CFIUS's concern about foreign access to sensitive personal information, including genetic and health information of U.S. persons. The forthcoming regulations will need to define what it means to be a business that "maintains or collects sensitive personal data of United States citizens that may be exploited in a manner that threatens national security." This, in turn, will determine whether acquisitions or investments in the life sciences area merit voluntary filings with CFIUS, as well as what investments involving foreign government-owned or controlled entities require mandatory declarations. CFIUS may also address the scope of "critical technologies," which currently includes a range of items developed by biotech companies.
- **Any other industry that collects, processes, or stores personal data**. Given the potential scope of "sensitive personal data," nearly any company that collects, processes, or stores significant amounts of such information may be implicated. This

includes financial services companies, insurance companies, medical services providers, IT service providers, telecommunications companies, software and application developers, and many others.

- **Aerospace and defense**. Many aerospace and defense companies currently fall within the scope of the Pilot Program, and will want to monitor how CFIUS updates those authorities. In addition, foreign aerospace and defense companies that regularly invest in the United States will want to consider the effect of the new procedural changes that CFIUS will make, including how those changes may align with the separate procedures relating to the mitigation of foreign ownership, control, or influence under national industrial security regulations, and with the export control authorities administered by the Department of Commerce (under the Export Administration Regulations) and the Department of State (under the International Traffic in Arms Regulations).
- **Real estate**. FIRRMA expanded CFIUS jurisdiction to review, for the first time, certain acquisitions of unimproved real estate that occur outside the context of an acquisition of control of a U.S. business. Specifically, FIRRMA provides that CFIUS has jurisdiction to review the purchase or lease by, or a concession to a foreign person, of public or private U.S. real estate that (a) is located within, or will function as part of, an air or maritime port, (b) is in close proximity to a United States military installation or another facility or property of the United States Government that is sensitive for reason relating to national security, and could reasonably provide the foreign person with the ability to collect intelligence on activities being conducted or could otherwise expose national security activities at such installation, or (c) meets such criteria as the Committee prescribes by regulation. FIRRMA contained general exceptions for single housing units and real estate in "urbanized areas" (although the exceptions are subject to modification by CFIUS through regulation). Among other things, the forthcoming regulations may address the meaning of "close proximity" to a U.S. government facility, other criteria to determine whether CFIUS has jurisdiction to review real estate transactions, and whether CFIUS will create any exemptions to the general rule that real estate in urbanized areas is excluded from the scope of the provision.

3. Will the regulations differentiate among countries or between private investors and state-owned enterprises ("SOEs")?

Likely, yes. FIRRMA subjects entities with foreign government ownership to heightened scrutiny and mandatory filing requirements for certain investments. Most directly, FIRRMA requires filings for investments in particular categories of U.S. businesses by "foreign persons in which a foreign government holds a substantial interest." The scope of this mandatory filing requirement was left for CFIUS to address in the regulations. SOEs especially should watch for:

- The definition of "substantial interest," including for example whether a limited partnership interest by an SOE in an investment fund may be considered a "substantial interest."
- The definitions of "critical infrastructure," "sensitive personal data," and "critical technology," which will determine the scope of U.S. businesses for which mandatory filings will apply.
- Whether CFIUS will use the "country specification" provision of FIRRMA to exempt investors from certain countries from mandatory filing requirements.

- Whether CFIUS will adopt a waiver process through which investors may apply for an exemption from mandatory filing requirements.

4. What other key issues will be addressed in the regulations?

In addition to the sector-specific items to watch noted above, the following are important issues to be addressed in the regulations that apply to all parties:

- **Definition of "Control."** Historically, whether there is CFIUS jurisdiction has turned on whether a foreign person will acquire "control" of a U.S. business. Under the existing statute and regulations, "control" means the power, direct or indirect, whether or not exercised, to determine, direct, or decide matters affecting an entity. The definition of control therefore is expansive and flexible, allowing CFIUS to analyze each transaction according to its particular facts and circumstances. This discretion in turn enables the Committee to make policy judgments regarding the targeted asset and the identity of the investors that may impact its conclusion as to the existence of "control" among different cases that otherwise have identical objective indicia of "control" (such as percentage of voting shares, number of directors, minority shareholder rights, and the like). This flexible definition was workable in CFIUS's pre-FIRRMA voluntary filing regime, but has created significant uncertainty now that certain filings are mandatory. We are watching to see whether CFIUS clarifies the definition of "control" especially in circumstances in which mandatory filing requirements may turn on that definition.
- **Filing fees**. FIRRMA for the first time authorized CFIUS to collect filing fees not to exceed one percent of the value of the transaction or $300,000, whichever is less. The actual fees will need to be set through regulation.
- **"U.S. business" definition**. FIRRMA defined "U.S. business" broadly to mean "a person engaged in interstate commerce in the United States." This extends beyond the existing regulatory definition, which includes the following qualifier: "but only to the extent of its activities in interstate commerce in the United States." CFIUS could clarify the scope of "U.S. business" by reapplying the qualifier in the new regulations as it had in the existing regulations. Absent such clarification, CFIUS conceivably could assert authority to review an acquisition of a business anywhere in the world so long as that business provides goods and services into the United States.
- **Implementation of declaration process**. FIRRMA authorized the short-form filing or "declaration" with a streamlined 30-day review process. To date, CFIUS has implemented the declaration process only for mandatory filings subject to the Pilot Program, but it will need to expand the process to be available for at least some voluntary filings as well. Notably, only a small percentage of declarations filed with CFIUS actually have been approved by the Committee at the end of thirty days; in the overwhelming number of cases, CFIUS either has requested a full notice or has declined to approve formally, allowing the parties to proceed with their transaction, albeit without the legal safe harbor. We are watching to see whether CFIUS will seek to adjust the process to permit more transactions to be approved through the declaration process.
- **Penalty provisions**. FIRRMA authorizes CFIUS to impose civil penalties for failure to submit mandatory filings. The regulations may provide guidance on when CFIUS will impose penalties and what factors the Committee will consider in adjudicating potential penalties.

5. What will be the process for finalizing the regulations, and when will the regulations become effective?

Once the Treasury Department publishes the regulations in the Federal Register in the form of a proposed final rule, parties will have a brief window in which to submit formal comments. At the end of that comment period, CFIUS will consider the comments and adopt a final rule. We expect that final rule will be published in early 2020 to provide at least 30 days' notice before the new regulations become effective. Under FIRRMA, the new regulations must be effective by February 13, 2020.

* * * *

We will continue to keep our clients and friends apprised of developments related to the implementation of FIRRMA.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our firm:

Mark Plotkin	+1 202 662 5656	mplotkin@cov.com
David Fagan	+1 202 662 5291	dfagan@cov.com
Stuart Eizenstat	+1 202 662 5519	seizenstat@cov.com
Alan Larson	+1 202 662 5756	alarson@cov.com
Peter Lichtenbaum	+1 202 662 5557	plichtenbaum@cov.com
John Veroneau	+1 202 662 5034	jveroneau@cov.com
David Marchick	+1 202 662 5514	dmarchick@cov.com
Heather Finstuen	+1 202 662 5823	hfinstuen@cov.com
Brian Williams	+1 202 662 5270	bwilliams@cov.com
Zachary Mears	+1 202 662 6000	zmears@cov.com
Stephen Rademaker	+1 202 662 5140	srademaker@cov.com
Jonathan Wakely	+1 202 662 5387	jwakely@cov.com
Ruchi Gill	+1 202 662 5131	rgill@cov.com
Charles Buker	+1 202 662 5139	cbuker@cov.com
Elena Postnikova	+1 202 662 5785	epostnikova@cov.com
Luman Yu	+1 202 662 5974	lyu@cov.com