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More Clarity, More Complexity: New CFIUS Rules Put Spotlight On Mandatory Filings

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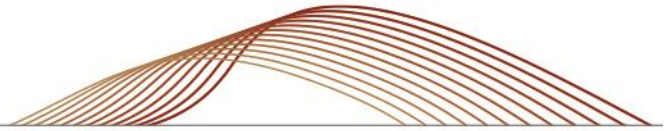
The Department of the Treasury has issued proposed rules that, upon becoming final, will revise the conditions under which parties to a foreign investment in any U.S. business that produces "critical technologies" are required to provide notice to the Committee on Foreign Investment in the United States ("CFIUS"). CFIUS is accepting written comments on the proposed rules until June 22, 2020. The new rules will provide greater clarity as to which foreign investments trigger a mandatory CFIUS filing by eliminating a criterion in the current rules (which often proved difficult to apply) that the targeted U.S. business use or deploy its technology in specified industry sectors. Instead, the mandatory filing requirement will be tied to a specific question: whether export or reexport of the target's "critical technology" to the jurisdiction(s) of the foreign investor(s) would require U.S. regulatory approvals. The approval regulations in question, which cut across several different U.S. agencies and export control regimes, can themselves be difficult to interpret and apply. But the change is intended to bring the CFIUS process in greater alignment with U.S. policy on technology export controls, training scrutiny on investments that could have the effect of undermining U.S. efforts to block the transfer of sensitive technologies to strategic rivals, regardless of industry sector. For the regulated investment community, the new rules will require a greater emphasis on early due diligence by qualified regulatory counsel to identify export control issues that could arise from an evaluation of the nature of the target's technology (whether civilian, military, or nuclear), potential end uses and specified categories of end users.

Background

Historically, parties could elect but were not required to seek clearance from CFIUS of transactions involving foreign investments in the United States, and CFIUS's jurisdiction was confined to foreign investment that could result in "control" of a U.S. business. The Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA"), enacted August 13, 2018, broadened CFIUS's authority to review and take actions to address national security concerns arising even from non-controlling investments involving foreign persons. FIRRMA also continued the largely voluntary nature of the CFIUS process with respect to most transactions. However, notification to CFIUS is now mandatory in two circumstances: covered investments (including some minority investments) in certain U.S. businesses that develop "critical technologies"; and transactions where a foreign government has a "substantial interest" in a foreign person investor that itself acquires a "substantial interest" in certain types of U.S. businesses.



In 2018, CFIUS implemented a "pilot program" with respect to the first type of mandatory declarations: investments in certain U.S. businesses that develop "critical technologies." Under that program, mandatory notifications were triggered if the U.S. business developed "critical technologies" in connection with 27 industry sectors identified by reference to the North American Industry Classification System ("NAICS"). The final rules implementing FIRRMA that took effect on February 13, 2020 largely incorporated the pilot program rules and added certain exemptions. In continuing the pilot program mandatory filing arrangements, CFIUS indicated that it intended, in the future, to dispense with the NAICS code rubric in favor of rules that would focus more on the nature of the technology developed by the U.S. target and less on how that technology was currently being used or deployed.[1]

The Proposed Rules

The proposed rules include three principal revisions to the mandatory filing requirements:

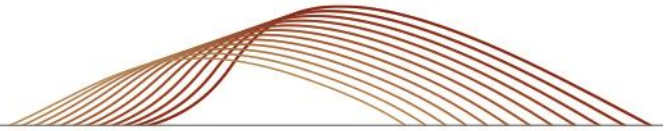
- First, they remove the NAICS code nexus to critical technologies. Transaction parties will no longer be charged with determining whether the U.S. business engaged in specific industries identified by reference to NAICS codes. This eliminates some of the "guesswork" from the current rules, as there is a decided lack of uniformity in how companies and their customers apply these codes to their businesses and supply chains.

- Second, the proposed rules introduce the concept of "U.S. regulatory authorization" by basing the declaration requirement instead on whether (1) "certain U.S. regulatory authorizations would be required to export, re-export, transfer (in country), or retransfer the critical technologies" produced by the U.S. target to certain transaction parties and foreign persons in the ownership chain,[2] and (2) the foreign person is a party to the transaction, and individually or in aggregate with other foreign persons, holds a voting interest (direct or indirect) of 25 percent or more.[3]

  - "U.S. regulatory authorization," in turn, is a reference to the licensing jurisdiction of multiple U.S. agencies under various export control regulatory regimes, including (i) an export license, technical assistance agreement or manufacturing license agreement issued or approved by the Department of State under International Traffic in Arms Regulations ("ITAR"), 22 C.F.R. Part 120 *et seq*; (ii) an export or reexport license from the Department of Commerce under the Export Administration Regulations ("EAR"), 15 C.F.R. Part 730, *et seq.*; (iii) a specific authorizations from the Department of Energy under 10 C.F.R. Part 810; or (iv) a specific license from the Nuclear Regulatory Commission under 10 C.F.R. Part 110.

  - Notably, as the Committee explains through several examples, CFIUS will only recognize certain, enumerated license exceptions to excuse the requirement to file a mandatory notice; thus, in some cases, parties would be required to notify CFIUS of a transaction even if the export or reexport of the investment target's technology to the foreign investor would be not require an actual license.

- Third, in a step that clarifies when a mandatory notice will be required in the second category (acquisition of a "substantial interest" in certain U.S. businesses by investors in which a foreign government itself has a "substantial interest"), the rules will be amended to provide that in the case of an entity whose activities are primarily directed, controlled, or coordinated by or on behalf of a general partner, the government of a foreign state will be



considered to have a "substantial interest" only if it holds 49 percent or more of the interests in the general partner in the aggregate.

These proposed rules are significant because they shift the analysis for whether a filing is mandatory away from particular industry sectors, and instead toward a square focus on export approval requirements. Once implemented, they will elevate substantially the role of rigorous exports controls and regulatory analyses in the due diligence stage of foreign investments. As failure to comply with the mandatory notice requirement can lead to significant monetary penalties—up to and including the full value of the investment—parties are well-advised to engage qualified counsel with expertise in CFIUS and export controls at the earliest stages of the transaction evaluation process.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Washington, D.C. lawyers:

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[1] *See* Provisions Pertaining to Certain Investments in the United States by Foreign Persons, 85 Fed. Reg. 3112, 3113 (Jan. 17, 2020), https://home.treasury.gov/system/files/206/Part-800-Final-Rule-Jan-17-2020.pdf; *see also* "Frequently Asked Questions on Final CFIUS Regulations Implementing FIRRMA" (https://home.treasury.gov/system/files/206/Final-FIRRMA-Regulations-FAQs.pdf) ("FIRRMA FAQs") at 6.

[2] 85 Fed. Reg. 30893, 30894 (May 21, 2020), https://www.govinfo.gov/content/pkg/FR-2020-05-21/pdf/2020-10034.pdf.

[3] *Id.* at 30898.