CFIUS Amends Mandatory Declaration Standards

May 22, 2020

On May 20, 2020, the Treasury Department issued proposed regulations to modify the scope of the mandatory declaration rules for transactions involving U.S. businesses involved in certain activities related to critical technologies ("**Proposed Mandatory Declaration Regulations**"). As described in further detail below, the Proposed Mandatory Declaration Regulations would reset the applicable trigger for mandatory declarations by essentially replacing the legacy "Pilot Program" with a new rule that is focused on whether export licenses would be required to export, re-export, transfer, or re-transfer the critical technology to the incoming foreign person investor. In addition, the Proposed Mandatory Declaration Regulations propose certain changes to definitions in current regulations, including clarifying definition of "substantial interest."

The Proposed Mandatory Declaration Regulations build upon the final regulations implementing the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA") that Treasury issued on January 13, 2020, which we summarized in our memo available **here**. The purpose of the Proposed Mandatory Declaration Regulations is to leverage the existing national security export control regimes, which require licensing or authorization based on an analysis of the national security implications of a particular item or technology, end user, and the particular foreign country for export, re-export, transfer, or retransfer.

The proposed regulations are not effective immediately, but rather remain subject to public comments, which are due on June 22, 2020. The existing critical technology mandatory declaration provisions will continue to apply until a final rule is implemented. At this time, the Committee on Foreign Investment in the United States ("CFIUS") has not identified a specific date on which the anticipated final rule will become effective.

Finally, in addition to the analysis of the Proposed Mandatory Declaration Regulations, this memo provides a brief summary of the recently released CFIUS Annual Report to Congress regarding transactions reviewed by CFIUS in 2018.

Notable Changes Effectuated by the Proposed Mandatory Declaration Regulations

Modified Scope of the Declaration Provision

Under the existing FIRRMA regulations, with certain exceptions, the parties to a transaction must file with CFIUS where (1) there has been a covered investment or covered control transaction involving (2) a U.S. businesses that produces, designs, tests, manufactures, fabricates, or develops one or more critical technologies and (3) the technology has some nexus to one of twenty-seven specified industries (each of which is defined by reference to a specific NAICS code). This approach essentially tracks the approach that CFIUS first took when it implemented the Pilot Program in 2018.

The proposed rule would establish a new regime by revoking the requirement for a nexus to one of the specified industries, and instead tying filing requirements more closely to export control restrictions and treating foreign investors (and, in some cases, investors in such investors) as foreign end-users of the technology in question. Specifically, the proposed rule would mandate a filing for any covered transaction "involving a TID U.S. business"[1] that produces designs, tests, manufactures, fabricates, or develops one or more critical technologies[2] if a "U.S. regulatory authorization" would be required to export such critical

[1] The definition of "TID U.S. business" would not change from the definition of that term in the existing regulations.

[2] The proposed rule does not modify the definition of ''critical technologies,'' which is defined by FIRRMA, and implemented at § 800.215 of Part 800 of the FIRRMA Regulations.

technology to the foreign investor or investors involved in the transaction. In addition, to trigger this new test, the proposed transaction must provide that the foreign party that would require such a "U.S. regulatory authorization":

- (i) Could directly control the U.S. business as a result of the transaction;
- (ii) Is directly acquiring an interest in the U.S. business that would constitute a covered investment;
- (iii) Is acquiring new or additional rights in the U.S. business, where such new or additional rights could result in a covered control transaction or a covered investment;
- (iv) Is a party to any transaction or agreement, the structure of which is designed or intended to evade or circumvent CFIUS jurisdiction; or
- (v) Individually holds, or is part of a group of foreign persons that, in the aggregate, holds, a "voting interest for purposes of critical technology mandatory declarations" in another foreign person that is otherwise covered by (i)-(iv) above.

Two concepts in this new rule require further elaboration:

- First, a "U.S. regulatory authorization" is essentially defined as a license or other formal authorization/approval under the applicable export control regime for the relevant critical technology.
    - Whether such a "U.S. regulatory authorization" is required must be determined without considering license exemptions under the International Traffic in Arms Regulations ("ITAR") or (with certain narrow exceptions described in the bullet below) license exceptions under the Export Administration Regulations ("EAR"). Thus, if a U.S. person would require a license in order to export the critical technology to the foreign party in the transaction, a "U.S. regulatory authorization" is generally needed, regardless of whether an established general exception in the regulations might apply.
    - The exceptions to this general rule are the exceptions in the EAR set forth in 15 CFR 740.13 (License Exception TSU), 740.17(b) (License Exception ENC)[3], and 740.20(c)(1) (License Exception STA).
    - To determine whether a U.S. regulatory authorization is needed, the "destination" for the exported technology is determined by the foreign person's principal place of business (for entities), or such foreign person's nationality or nationalities (for individuals).
    - The foreign person is considered the "end user" of the technology for purposes of determining whether a U.S. regulatory authorization is needed.
- Second, the concept of "voting interest for purposes of critical technology mandatory declarations" would be defined as a voting interest of 25 percent or more.
    - Where the foreign person's activities are primarily directed or controlled by a general partner or managing member (such as most fund investors), the "voting interest" requirement is met only if the foreign person holds a 25 percent or greater interest in that general partner or managing member. Accordingly, foreign limited partners in a fund will generally not be deemed to have a "voting interest for purposes of critical technology mandatory declarations."

[3] The proposed regulation revises the exception for encryption commodities, software, and technology ("ENC") to specify that only subpart (b) of this exception applies. In its comments, the Treasury Department reasoned that, "[t]he scope of that exception is narrowed in the proposed rule in order to provide clarity regarding the applicability of certain subparts of that exception in the context of mandatory declarations."

- The individual interests of multiple foreign persons that are related, have formal or informal arrangements to act in concert, or are controlled by the same foreign government are aggregated together for purposes of determining whether the "voting interest for purposes of critical technology mandatory declarations" has been met.

Implications of the Proposed Rule

If implemented in its current form, the Proposed Mandatory Declaration Regulations could have numerous implications for foreign investors and U.S. acquisition targets. A non-exhaustive list of such potential implications is set out below:

- The proposed rule would expand the range of transactions for which a filing would be at least theoretically mandatory. Under this proposed rule, any covered investment or covered control transaction directly entered into by a non-excepted investor in a U.S. business that produces designs, tests, manufactures, fabricates, or develops one or more critical technologies is likely to be subject to the mandatory filing rule. Parties to such transactions can no longer rely on the industry nexus requirement to avoid this rule (although in practice, some foreign investors have been reluctant to rely on this requirement in any case).
- The proposed rule does not, however, mandate filings by foreign persons that would not require an export license to receive the U.S. company's critical technology. For example, if a Belgian person acquired a controlling stake in a U.S. business that manufactures items controlled under "NS Column 2" of the EAR, the parties would not be required to file with CFIUS based on those facts alone, because no export license is required to export items controlled solely under "NS Column 2" to Belgium. If the acquiring entity were Chinese or Brazilian, however, a filing would be mandatory, since that item could not be exported to China or Brazil without obtaining a license.
- In the example above, note that if the firm investing in the U.S. business remained Belgian, but a Chinese or Brazilian investor owned a 25 percent or greater voting interest in that firm, then a filing with CFIUS would again be mandatory. In that case, the Chinese or Brazilian investor would be considered to have a "voting interest for purposes of critical technology mandatory declarations."

Modified Definition of Substantial Interest

The Proposed Mandatory Declaration Regulations add language to the definition of "Substantial interest," clarifying that § 800.244(b) applies only where the general partner, managing member, or equivalent primarily directs, controls, or coordinates the activities of the entity. The proposed rule also clarifies that the analysis to determine the percentage of interest held indirectly by one entity in another entity, as specified in § 800.244(c), applies to both § 800.244(a) and § 800.244(b).

Applicability of the Proposed Rule

The Proposed Mandatory Declaration Regulations modify § 800.104 to clarify the applicability period of the provisions of Part 800 of the FIRRMA regulations. The Pilot Program Interim Rule will continue to apply to transactions for which specified actions occurred on or after November 10, 2018, and prior to February 13, 2020. The existing critical technology mandatory declaration provision based on NAICS codes and published on January 13, 2020 will apply to transactions for which specified actions occurred from February 13, 2020, until the Proposed Mandatory Declaration Regulations enter into force.

Looking Forward

The Proposed Mandatory Declaration Regulations refine FIRRMA's effort to define critical technology in terms of export classification. Treating foreign investors as the end-users of targets' critical technology

allows for more differentiation among investors by country of origin without creating "blacklists" or expanding the list of excepted foreign states. By making an investor's nationality depend on the nationality of any given 25% stakeholder, however, the proposed regulation adds even more complexity to the early stages of transactions and makes the principal place of business of an investor's investors an issue for a target evaluating bids. If adopted as currently written, the Proposed Mandatory Declaration Regulations are likely to expand the number of transactions potentially subject to mandatory filings and, therefore, to inject CFIUS planning even earlier in the investment or acquisition process.

CFIUS Annual Report to Congress

In May 2020, CFIUS released its **Annual Report to Congress** regarding its review of foreign investment transactions in 2018 ("Annual Report"). The Annual Report presents a first-look at the data collected by CFIUS following the enactment of FIRRMA in August 2018. Although FIRRMA's regulations were not fully implemented until February 13, 2020 (and thus after the period covered by the Annual Report), certain provisions in FIRRMA took effect immediately, and the impact of those changes is at least partially reflected in this report. In addition, CFIUS's Pilot Program commenced on November 20, 2018, so the report also reflects some insights into the impact of that program, including mandatory declarations.

Below are a few key observations from the Annual Report:

- CFIUS received 229 notices in 2018, down slightly from the number of notices in 2017 (237), but still far more than any other year on record. After accounting for the 21 declarations that were filed with CFIUS under the Pilot Program, however, the total number of filings with CFIUS increased.
    - CFIUS commenced an investigation for 69 percent of the notices it received (158 of 229), also down slightly from 2017 (73 percent).
    - CFIUS concluded action after imposing mitigation for 13 percent of the notices it received (29 of 229), which is approximately the same proportion as in 2017.
- Of the 229 notices, 29 percent were withdrawn (66 of 229).
    - In 34 instances, the parties filed a new notice in 2018, and in eight of these instances, the parties filed a new notice in 2019.
    - In 18 instances, the parties withdrew the notice and abandoned the transaction, either because CFIUS informed the parties that it was unable to identify mitigation measures that would resolve its national security concerns, or because CFIUS proposed mitigation measures that the parties chose not to accept.
    - In three instances, the parties withdrew their notice and abandoned the transaction for commercial reasons unrelated to CFIUS review. In two instances, CFIUS permitted the parties to withdraw their notice subject to certain conditions.
- In 2018, of the 229 total notices received, 55 notices (24 percent) pertained to acquisitions by Chinese investors.
- Mitigation measures negotiated and adopted in 2018 included:
    - Prohibiting or limiting the transfer or sharing of certain intellectual property, trade secrets, or know-how;
    - Establishing guidelines and terms for handling existing or future USG contracts, USG customer information, and other sensitive information;
    - Ensuring that only authorized persons have access to certain technology; that only authorized persons have access to USG, company, or customer information; and that the foreign acquirer not have direct or remote access to systems that hold such information. • ensuring that only U.S. citizens handle certain products and services, and ensuring that certain activities and products are located only in the United States;

  - Establishing a Corporate Security Committee and other mechanisms to ensure compliance with all required actions, including the appointment of a USG-approved security officer or member of the board of directors and requirements for security policies, annual reports, and independent audits;
  - Assurances of continuity of supply for defined periods, and notification and consultation prior to taking certain business decisions, with certain rights in the event that the company 25 decides to exit a business line. Establishing meetings to discuss business plans that might affect USG supply or national security considerations; and
  - Exclusion of certain sensitive assets from the transaction or complete divesture of all or part of the U.S. business.
- In 2018, CFIUS received 21 declarations pursuant to the Pilot Program.
  - CFIUS cleared only two such transactions.
  - For the remaining 19 declarations:
    - In 11 instances, CFIUS determined that it could not conclude action;
    - In 5 instances, CFIUS requested the parties to file a notice;
    - In one instance, CFIUS concluded that the transaction was not subject to the jurisdiction of the pilot program; and
    - In one instance, the parties withdrew the declaration for business reasons.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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