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CFIUS Regulations for Foreign Investment in the U.S.

Meeting FINSA Requirements and Leveraging Lessons from Recent Transactions

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Committee on Foreign Investment in the United States (CFIUS)

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Purpose and Composition

- **CFIUS is an interagency committee authorized to review transactions that could result in control of a U.S. business by a foreign person, in order to determine the effect of such transactions on the national security of the United States.**
- **CFIUS is composed of:**
  - **Nine member Executive Branch Departments** (Treasury-chair, State, Defense, Justice, Commerce, Energy, and Homeland Security) **and White House Offices** (USTR and OSTP)
  - **Two non-voting members** (Office of the Director of National Intelligence and the Department of Labor)
  - **Five observer White House Offices** (OMB, CEA, NEC, NSC, and HSC)

Authority, Rules, and Guidance

1. **Section 721** of the Defense Production Act of 1950, as amended by the Foreign Investment & National Security Act (FINSA) of October 2007, 50 U.S.C. App. § 2170.
2. **Executive Order 11858**, as amended by Executive Order 13456
3. **CFIUS Regulations**, 31 C.F.R. Part 800, Final Rule published at 73 Fed. Reg. 70702 (Nov. 21, 2008)
4. **Guidance** Concerning the National Security Review Conducted by CFIUS, 73 Fed. Reg. 74567 (Dec. 8, 2008)
5. **www.treasury.gov/cfius**

Covered Transactions

- **"Any transaction . . ., by or with a foreign person, which could result in control of a U.S. business by a foreign person."** **§ 800.207**
  - "Transaction" - § 800.224
  - "Foreign Person" - § 800.216
  - "Control" - § 800.204
  - "U.S. business" - § 800.226
- **Numerous examples in these sections to illustrate these terms**
- **Numerous examples in §§ 800.301 and 302 addressing, e.g., "*could* result in control," collections of assets, multinational companies, joint ventures, supply contracts, and technology licenses**
- **Special rules in §§ 800.304 and 305 to describe treatment of loans and convertible instruments, respectively**

National Security Analysis

- **"National security risk" is a function of the interaction between threat and vulnerability, and the potential consequences of that interaction for U.S. national security.**
  - **Threat** – Whether a foreign person has the capability or intention to exploit or cause harm.
  - **Vulnerability** – Whether the nature of the U.S. business, or its relationship to a weakness or shortcoming in a system, entity, or structure, creates susceptibility to impairment of national security.
- **Additional illustration**
  - Section 721(f) lists national security factors for CFIUS consideration.
  - Guidance published by CFIUS summarizes transactions that have been filed with CFIUS that have presented national security considerations.

National Security Analysis

- **CFIUS concludes action on a covered transaction when it has determined that there are no "unresolved national security concerns" with a transaction. It makes this determination if it finds that:**
  - The transaction does not pose any national security risk,
  - Any national security risk is adequately and appropriately addressed by other authorities, or
  - CFIUS negotiates or imposes mitigation to resolve the identified risk.
    - Mitigation process stated in Executive Order § 7
    - Agency will prepare a written "risk-based analysis" describing the threat, vulnerability, consequences, and risk and recommending mitigation measures
    - If approved by CFIUS, Treasury and co-lead agency will seek to negotiate agreement with parties
- **If CFIUS cannot determine that there is no unresolved national security concern, it will refer the matter to the President for a decision, and in the appropriate circumstances will include a recommendation that he suspend or prohibit the transaction. Only the President has this suspension and prohibition authority.**

Process

- **Pre-filing - § 800.401(f)**
- **Cases can be initiated pursuant to:**
  - Voluntary notice - §§ 800.401(a) and 402
  - CFIUS request and notice filed by parties - § 800.401(b)
  - Agency notice - § 800.401(c)
- **CFIUS may pose questions to the parties, with responses due in 3 business, unless extended**
- **Time frame:**
  - 30-day "review"
  - Up to 45-day "investigation," as necessary - § 800.503
  - Up to 15 days for Presidential decision, as necessary - § 800.506
- **Safe harbor defined in § 800.601**
  - CFIUS advises parties that transaction is not a covered transaction
  - CFIUS advises parties that it has concluded all action
  - The President has announced his decision not to exercise his authority

2008-2011

Covered Transactions, Withdrawals, and Presidential Decisions 2009 -2011					
Year	**Number of Notices**	**Notices Withdrawn During Review**	**Number of Investigations**	**Notices Withdrawn During Investigation**	**Presidential Decisions**
2009	65	5	25	2	0
2010	93	6	35	6	0
2011	111	1	40	5	0
Total	**269**	**12**	**100**	**13**	**0**

Covered Transaction by Sector and Year, 2008-2010					
Year	**Manufacturing**	**Finance, Information, and Services**	**Mining, Utilities, and Construction**	**Wholesale and Retail Trade**	**Total**
2008	72 (46%)	42 (27%)	25 (16%)	16 (10%)	155
2009	21 (32%)	22 (34%)	19 (29%)	3 (5%)	65
2010	36 (39%)	35 (38%)	13 (14%)	9 (10%)	93
Total	**129 (41%)**	**99 (32%)**	**57 (18%)**	**28 (9%)**	**313**

Table C-1: Covered Transactions by Sector and Year, 2008-2010

CFIUS: Process and Strategic Considerations

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DISCUSSION TOPICS

I. CFIUS Filings: Key Considerations

II. The CFIUS Review and National Security Considerations

III. Mitigation Agreements and Penalties

IV. Team Telecom

V. Various CFIUS Cases: a Discussion

I. CFIUS Filings: Key Considerations

A. Typical CFIUS Filers

B. Control and Key Filing Issues

C. Pre-filing Engagement

- With CFIUS
- Outside of CFIUS

D. Purchase Agreement Considerations

I.A. CFIUS Filings: Typical Filers

- Foreign investors who make "controlling investments" in U.S. businesses that have national security considerations, such as:
  - Classified defense or homeland security-related contracts
  - Sole source or sensitive contracts with federal, state or local governments
  - Critical or emerging technologies and infrastructure
  - Export control restrictions, including ITAR, EAR and OFAC
- Foreign government-controlled investors who make sensitive investments

I.B. CFIUS Filings: Control in the CFIUS Process

- It is a functional test; therefore, there are no bright lines. It can involve:
  - Making a majority, dominant minority or controlling minority investment in a U.S. business,
  - Having the ability to "determine, direct or decide important matters," even if with a 10% or less equity stake, through:
    - appointing directors, reorganizing, merging or dissolving a business
    - appointing and/or dismissing executive officers
    - controlling budget matters, accessing proprietary data, etc
- Control is treated as a binary concept: If an acquisition confers control, subsequent acquisitions of additional shares by same person does not "result in" control.
- There are a number of minority rights which do not confer control.
  - *See* 31 C.F.R. §800.204(c), and discussion of Final Rule.

I.B. CFIUS Filings: Key Filing Issues

- Personal Identifier Information
- Investigation Triggers
- Critical Infrastructure
- Foreign Government Control

I.C. CFIUS Filings: Pre-filing Engagement with CFIUS and CFIUS Agencies

- Pre-filings are strongly encouraged (5 business days before filing)
  - It is useful to contact Treasury before a pre-filing
- CFIUS does not issue advisory opinions as to whether a transaction is a covered transaction or whether it raises national security concerns.
- All pre-filing information and documentary materials made available as part of pre-filing consultations are considered confidential.
- Consider meeting with other CFIUS agencies:
  - The Department of Commerce on Export Administration Regulations (EAR)
  - The Department of State on International Traffic in Arms Regulations (ITAR)
  - The Department of Treasury's Office of Foreign Assets Control (OFAC) on sanctions issues

I.C. CFIUS Filings: Engagement Outside the CFIUS Process

- Congress
  - Only when appropriate
  - Confidentiality considerations
  - Know the key Committees and Members
- Media
  - Have a press plan
- State and Local Governments
  - Get buy-in at the local level
  - Get labor behind you

I.D. CFIUS Filings: Purchase Agreement Considerations

- Does your purchase agreement contemplate the various forms of CFIUS approval?
- Does your agreement include “best efforts” language that covers CFIUS obligations?
- Does your agreement account for potential CFIUS mitigation?
- Does your agreement account for related processes, *i.e.*, DSS?

II. The CFIUS Review and National Security Considerations

A. The CFIUS Assessment

B. Threat

C. Vulnerability

D. National Security Considerations

II.A: The CFIUS Assessment:

The Analysis Formulas

Risk **= Threat + Vulnerability + Consequences**

Mitigation **= Risk – Other Provisions of Law (including regulation & policy)**

Note: CFIUS bases its analysis on an assumption of full control

II.B. The CFIUS Assessment:

THREAT

- **Threat assessments derive primarily from the foreign actor.**
  - On Day 20 of a review, CFIUS receives a threat assessment from the Director of National Intelligence (DNI).
  - The assessment includes input from up to 16 intelligence agencies.
- **Threat considerations include, among others:**
  - ✓ The foreign person's track record on issues that could impair U.S. national security, *e.g.*, export controls
  - ✓ The foreign person's intentions on issues that could impair national security, *e.g.*, to terminate government contracts
  - ✓ For government-controlled companies, the foreign government's history with regard to national security matters, *e.g.*, non-proliferation
  - ✓ Others

II.C. The CFIUS Assessment:

VULNERABILITY

- **Vulnerability assessments derive primarily from the U.S. business.**
  - Does the U.S. business provide products and services as a prime contractor, subcontractor or supplier to Federal agencies and/or state and local government authorities?
    - ✓ This includes classified, sole source, or sensitive work for defense, security, or national security-related law enforcement sectors regarding:
      - Weapons and munitions manufacturing, aerospace and radar systems, among others
      - Businesses relevant to national security, such as information technology, telecommunications, energy, natural resources, industrial products and goods and services that present vulnerability to sabotage or espionage
  - Is the U.S. business an important part of U.S. infrastructure?
    - ✓ Energy (pipelines); transportation (ports); and financial systems
  - Does the U.S. business engage in R&D, production or sale of technology, goods, software or services involving semiconductors, cryptography, data protection, internet security, network intrusion detection and/or other areas subject to U.S. export controls?

II.D. The CFIUS Assessment: National Security Considerations

- **National security considerations primarily derive from:**
  - *All national security factors identified in section 721, including:*
    - ✓ Effects on domestic production needed for national defense requirements
    - ✓ Effects of a foreign person's control of domestic industries and commercial activity on the capability and capacity of the United States to meet national security requirements
    - ✓ Effects on U.S. critical technologies
    - ✓ Effects on long-term requirements for energy and other critical resources
    - ✓ Effects on critical infrastructure, including major energy assets
    - ✓ Effects of control by a foreign government, focusing on nonproliferation and cooperation on counter-terrorism
    - ✓ Effects on potential transshipment or diversion of military technologies, including an analysis of national export control laws and regulations
  - *Other factors considered relevant to national security, for example:*
    - ✓ Classified, sole source or sensitive U.S. government contracts
    - ✓ Espionage, corruption or terrorism

III. Mitigation Agreements and Penalties

A. Mitigation Agreements

B. CFIUS Penalties

III.A. Mitigation Agreements

- Negotiated “on behalf of Committee” based on risk-based analysis.
- Lead agency monitors and enforces mitigation measures on behalf of Committee.
- CFIUS has the ability to require mitigation.
- Mitigation also occurs through NISPOM and Team Telecom processes.
- E.O. 11858, as amended by E.O. 13456, conditions mitigation agreements and terms.

III.B. CFIUS Penalties

- The FINSA regulations address penalties at 31 C.F.R. 800.801.
- Any person who intentionally or through gross negligence submits a material misstatement or omission in a notice or makes a false certification to CFIUS may be liable for a civil penalty up to $250,000 per violation.
- Any person who intentionally or through gross negligence violates a material provision of a mitigation agreement may be liable for a civil penalty up to $250,000 per violation or the value of the transaction, whichever is greater.
  - Civil penalties are enforceable in an action brought by the U.S. Department of Justice in federal district court.
- The regulations also provide CFIUS with the authority to negotiate and enforce clauses providing for actual or liquidated damages in mitigation agreements set at a "reasonable assessment of the harm to the national security that could result from a breach of the agreement."

Intersection of CFIUS Process & Other National Security Review Processes: FOCI & Export Controls

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Overview

- Transactions notified to the Committee on Foreign Investment in the United States ("CFIUS") can have related but parallel national security regulatory implications
- Cleared target
  - Separate notification
  - Plan to maintain security clearances following closing
- Target engaged in export-controlled activities
  - Due diligence
  - Potential separate notification
- These issues can have significant post-closing impacts, so it is critical to do due diligence and come up with a strategy to ensure the business will continue to operate successfully and in a manner acceptable to the buyer following closing

Foreign Ownership, Control or Influence Overview

- A company under foreign ownership, control or influence ("FOCI") is not eligible to be issued a facility security clearance ("FCL") or continue to hold an FCL unless its FOCI is mitigated in accordance with the National Industrial Security Program Operating Manual ("NISPOM") in a manner acceptable to the U.S. Government
- A U.S. company is considered to be under FOCI when a foreign interest has the power, direct or indirect, whether or not exercised, to direct or decide matters affecting the management or operations of the company in a manner which may result in unauthorized access to classified information or may affect adversely the performance of classified contracts (NISPOM, paragraph 2-300a)
  - Even a minority interest can constitute FOCI
- The Defense Security Service ("DSS") administers the NISP on behalf of the Department of Defense ("DoD") and 24 non-DoD agencies, and is responsible for examining foreign involvement in U.S. companies that are in the process of obtaining a DoD FCL or that hold a DoD FCL
- The Department of Energy ("DoE") fulfills this role for DoE FCLs
  - The DoD FOCI program is significantly larger than the DoE's

FOCI Mitigation Arrangements

- In **majority** foreign ownership cases, FOCI is mitigated via a Special Security Agreement, Proxy Agreement, or a Voting Trust
  - Special Security Agreement ("SSA"): Premised on the concept of risk mitigation
    - Minority foreign representation on the board
    - Requires the appointment of independent Outside Directors
    - Under an SSA, National Interest Determinations ("NID") required for access to "proscribed" classified information, i.e., Top Secret, Sensitive Compartmented Information, Special Access Program, Communications Security (excluding controlled cryptographic items when unkeyed or utilized with unclassified keys), and Restricted Data
    - Under statute (10 USC 2536), absent a Secretarial waiver as delegated, a company that is determined to be under foreign government control is not eligible for a NID; such companies can only perform on proscribed contracts under a Proxy Agreement
  - Proxy Agreement/Voting Trust: Premised on the concept of risk avoidance
    - Foreign representation on board prohibited
    - Proxy Holders/Trustees control the company, subject to limited authority of foreign owner
- In **minority** foreign ownership cases, the FOCI mitigation arrangement depends on whether the foreign investor is entitled to board representation or not
  - Security Control Agreement ("SCA"):
    - Used in cases of minority foreign investor board representation
  - Board Resolution:
    - Used in cases with no foreign investor board representation

FOCI Statistics

- More than 9,500 companies and 13,000 facilities in the DoD's National Industrial Security Program
- The DoD's FOCI program currently includes more than 330 companies and almost 800 facilities, broken down (approximately) as follows:
  - 110 SSAs
  - 33 Proxy Agreements
  - 28 SCAs
  - 162 Board Resolutions

FOCI Strategy

- Perform due diligence to assess the nature and extent of the target's classified business
  - Does the target perform on proscribed classified contracts?
  - How much of the target's revenue is based on classified work?
- Determine the desired FOCI mitigation arrangement
- Engage DSS (or DOE, as appropriate) before beginning the CFIUS process to provide an overview of the transaction and the intended FOCI mitigation plan
  - Helps identify any issues and avoid surprises later in the process
  - Provides DSS (or DOE) with additional time to conduct its analysis, which can help avoid delays in the CFIUS process

FOCI Filings

- The target must notify DSS (or DOE, as appropriate) when it "enters into negotiations for the proposed merger, acquisition, or takeover by a foreign interest" (NISPOM, paragraph 2-302b)
  - Typically done following execution of a Letter of Intent
  - Notice should be provided even for minority investments
- Submit proposed FOCI mitigation plan and supporting documents, including
  - Draft post-closing SF 328 (Certificate Pertaining to Foreign Interests)
  - Key Management Personnel forms
  - Draft compliance plans
- For a new FOCI mitigation plan, the buyer will need to nominate Outside Directors or Proxy Holders
- The parties will need to enter into a Commitment Letter to govern during the period between closing and the establishment of a new FOCI-mitigation arrangement

Export Control Due Diligence

- It is critical to assess the target's compliance with U.S. trade compliance laws to avoid successor liability—or at least to understand any risk being assumed
  - Consequences for violations can include fines and debarment
- It is necessary to understand the manner in which the U.S. business's products and services are controlled under U.S. export control laws—even if the target never exports
  - The CFIUS notice requires the U.S. business to specify how its products and services are controlled under U.S. export control laws
  - If a U.S. company manufactures products that are controlled under the International Traffic in Arms Regulations ("ITAR"), it must register with the U.S. Department of State's Directorate of Defense Trade Controls ("DDTC")
    - Small companies are often unaware of this requirement and are not registered even though they manufacture ITAR-controlled items
- Export control due diligence should also address other trade compliance issues, including the U.S. business's compliance with the Foreign Corrupt Practices Act, U.S. trade sanctions, and Antiboycott laws

Export Compliance Filings

- Once the parties have agreed to proceed with the deal, they must comply with ITAR filing requirements if the U.S. business is (or should be) registered under the ITAR
  - The target must file notice of the transaction with the DDTC at least 60 days prior to closing
    - This is a notification only, not a request for approval
  - The target must file a final notice letter with the DDTC within 5 days following closing
  - If the buyer has an ITAR-registered U.S. subsidiary, that company must also submit pre- and post-closing notice letters
- The target should file voluntary disclosures for any potential violations discovered during due diligence
- Recently, DDTC has been sending parties follow-up questions related to notified transactions

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IV. Team Telecom – Who it is and What it Does

- Team Telecom is an informal gathering of officials from the Departments of Homeland Security and Justice, and the FBI.
- It reviews FCC licenses as part of the FCC's obligation to consider the "public interest" with respect to various applications, including:
  - Section 214 authority
  - Cable landing licenses
  - Applications that involve more than 25 percent indirect foreign ownership
- Team Telecom can require parties to enter into a Network Security Agreement (NSA).
- Because it is not a creature of statute or regulations, Team Telecom has no formal rules, procedures or timetables.

Various CFIUS Cases: a Discussion

- Issues raised by recent investments
  - Dubai Ports
  - Alcatel/Lucent
  - Others