

CFIUS: FIRRMA Pilot Program Mandates Notification for Certain Critical Technology Transactions

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On October 10, 2018, the Department of the Treasury, which chairs the Committee on Foreign Investment in the United States (CFIUS), released an [interim rule](#) establishing a pilot program implementing portions of the Foreign Investment Risk Review Modernization Act (FIRRMA), which was [enacted in August](#). The pilot program involves two primary changes: (1) expanding CFIUS's jurisdiction to cover certain non-controlling, non-passive investments in companies involved with critical technologies within a specific subset of industries, and (2) mandating that parties file declarations—which FIRRMA describes as “abbreviated notifications that would not generally exceed 5 pages in length”—for all transactions covered by the pilot program. Mandatory declarations, authorized under FIRRMA, are a key change to the CFIUS process, which has historically been ostensibly voluntary. Moreover, failure to submit a mandatory declaration when required under the pilot program can result in potentially significant penalties—up to the value of the transaction. The following alert addresses the key aspects of the pilot program.

Transactions Covered by the Pilot Program

The pilot program's applicability depends on both the nature of the US business and the rights that the foreign investor will receive with respect to the US business.

Nature of the US Business—Pilot Program Applies to US Businesses Involved with Critical Technologies, but Only in Connection With Certain Specified Industries

The pilot program focuses exclusively on US businesses that produce, design, test, manufacture, fabricate, or develop a critical technology that is (a) utilized in connection with the US business' activity in one or more pilot program industries, or (b) designed by the US business specifically for use in one or more pilot program industries. Such a business is referred to as a "pilot program US business". To be considered a pilot program US business, a US business must satisfy both the critical-technology and relevant-industry elements of this definition.

Critical Technologies

The interim rule's definition of "critical technologies" conforms to the definition in FIRRMA, and means any of the following:

- defense articles or defense services included on the [United States Munitions List](#) set forth in the International Traffic in Arms Regulations (ITAR);
- items included on the Commerce Control List set forth in [Supplement No. 1 to part 774](#) of the Export Administration Regulations (EAR) (15 CFR parts 730-774) and controlled:
 - pursuant to multilateral regimes, including for reasons relating to national security, chemical and biological weapons proliferation, nuclear nonproliferation, or missile technology; or
 - for reasons relating to regional stability or surreptitious listening;
- specially designed and prepared nuclear equipment, parts and components, materials, software, and technology covered by [10 CFR part 810](#) (relating to assistance to foreign atomic energy activities);
- nuclear facilities, equipment, and material covered by [10 CFR part 110](#) (relating to export and import of nuclear equipment and material);
- select agents and toxins covered by [7 CFR part 331](#), [9 CFR part 121](#), or [42 CFR part 73](#); or
- emerging and foundational technologies controlled pursuant to section 1758 of the Export Control Act of 2018, which was included (along with FIRRMA) in the National Defense Authorization Act for Fiscal Year 2019.

This last category—emerging and foundational technologies—has yet to be defined and is subject to forthcoming guidance from the Commerce Department, which is expected imminently.

Pilot Program Industries

There are 27 pilot program industries identified by NAICS codes, which are included as an annex to this client alert. The Department of the Treasury notes that the US Government selected industries in which "certain strategically motivated foreign investment" could pose a threat to "US technological superiority" and national security. As with FIRRMA's "modernization" of CFIUS in general, the selected industries likely reflect concerns with Chinese investment trends, and likely serve as a substitute for the Chinese investment restrictions that had been contemplated in connection with the Section 301 investigation conducted earlier this year. Investment restrictions under Section 301 were ultimately deferred in light of the imminent passage of FIRRMA.

Rights of the Foreign Investor—Pilot Program Covers Both Controlling and Certain Non-Controlling Investments

Pilot Program Covered Transactions

The pilot program applies to (a) any transaction that could result in “control” of a pilot program US business by a foreign person, and (b) any “pilot program covered investment”. These are referred to as “pilot program covered transactions”.

A control transaction under the pilot program is consistent with the long-standing definition of a “covered transaction” under the CFIUS regulations, though it only applies with respect to a transaction in which the target is a pilot program US business.

A pilot program covered investment, however, reflects a key expansion of CFIUS’s jurisdiction to non-controlling, non-passive investments. A pilot program covered investment is any investment, direct or indirect, by a foreign person in an unaffiliated pilot program US business that does not afford the foreign person control over the pilot program US business but does afford the foreign person at least one of the following (which we refer to as “Covered Investment Rights”):

1. Access to any material nonpublic technical information¹ in the possession of the pilot program US business;
2. Membership or observer rights on the board of directors or equivalent governing body of the pilot program US business or the right to nominate an individual to a position on the board of directors or equivalent governing body of the pilot program US business; or
3. Any involvement, other than through the voting of shares, in substantive decision-making of the pilot program US business regarding the use, development, acquisition, or release of critical technology.

As authorized under FIRRMA, the pilot program marks the first time that CFIUS has authority to review transactions that do not result in control (an already broadly defined and interpreted concept under the CFIUS regulations) of a US business by a foreign person. Moreover, while FIRRMA authorizes CFIUS to limit its review of non-controlling investments to certain categories of foreign persons, CFIUS elected not to adopt such limitations for the pilot program.

Investment Funds

The interim rule contains a provision regarding the “treatment of certain investment fund investments,” which states that an indirect investment by a foreign person in a pilot program US business through an investment fund that affords the foreign person membership as a limited partner (or equivalent) on an advisory board or a committee of the fund, shall **not** be considered a pilot program covered transaction with respect to that foreign person if all of the following criteria are met:

1. The fund is managed exclusively by a general partner (or equivalent) that is not the foreign limited partner;
2. The advisory board/committee does not have the ability to approve/disapprove/control investment decisions of the fund or decisions by the general partner with respect to the fund’s portfolio assets;
3. The foreign limited partner cannot otherwise control the fund;

¹ Material nonpublic technical information means information that is not available in the public domain, and is necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods. Material nonpublic technical information does not include financial information regarding the performance of an entity.

4. The foreign limited partner does not have access to material nonpublic technical information as a result of its participation on the advisory board or committee; and
5. The investment otherwise meets the requirements of “other investments” (i.e., non-passive, non-controlling transactions) set forth in FIRRMA.

The investment fund provision, however, creates notable ambiguities. It is not clear, for example, whether the investment fund provision is meant to be an exception to what can constitute a pilot program covered transaction or if it effectively creates a new category of pilot program covered investments for fund investments where a foreign limited partner serves on an advisory board or committee of the fund. Interpreted one way, this provision requires foreign limited partners who sit on fund advisory boards or committees to satisfy additional criteria for their indirect investment in a pilot program US business through the fund to not be considered a “pilot program covered investment”. Interpreted another way, this provision might exempt indirect investments by such foreign limited partners through a fund from being “pilot program covered investments” if they meet the five criteria above, even if the foreign limited partners have Covered Investment Rights in the pilot program US business.

Particularly given the steep potential penalties for failure to submit mandatory declarations, it is critical that CFIUS clarify these points so that investment funds and their investors can properly comply with the pilot program requirements.

Mandatory Declarations Required for All Transactions Subject to the Pilot Program

Historically, CFIUS has been ostensibly a voluntary process. This changed, however, when FIRRMA established CFIUS’s authority to require declarations—“abbreviated” filings subject to a shorter review period—in certain cases. The interim rule requires that parties submit declarations for all pilot program covered transactions, whether controlling or non-controlling. Parties have the option to submit a full notice in lieu of a declaration. The declaration process is only available for pilot program covered transactions; declarations may not be submitted for transactions that are not subject to the pilot program.

Effectiveness

The pilot program takes effect on November 10, 2018. It does not apply (a) with respect to transactions that have closed prior to November 10, 2018, or (b) where prior to October 11, 2018, (i) the parties have executed a binding written agreement or other document establishing the terms of the transaction, (ii) a party has made a public offer to shareholders to buy shares of a pilot program US business, or (iii) a shareholder has solicited proxies in connection with the election of the board of directors of a pilot program US business or has requested the conversion of convertible voting securities. The pilot program will end no later than March 5, 2020.

Timing & Disposition

Mandatory declarations must be submitted at least 45 days prior to closing. FIRRMA specifically authorizes CFIUS to suspend closing for a transaction under review or investigation that may pose a national security risk, so this timing requirement—combined with the pilot program declarations being mandatory—could facilitate CFIUS’s ability to act on transactions that present national security concerns before they close. For pilot program covered transactions that will close between November 10, 2018, and December 25, 2018, a mandatory declaration must be submitted by November 10, 2018, “or promptly thereafter”.

Consistent with FIRRMA, the interim rule states that CFIUS shall have 30 days to review a declaration; however, the interim rule states that the 30-day period starts **after** the CFIUS Staff Chairperson has transmitted the declaration to the Committee—a process that happens after the Staff Chairperson has inspected the declaration for completeness and accepted it. The interim rule states that the Staff Chairperson shall “promptly” inspect the declaration and notify the parties of acceptance or return the declaration with specific guidance on what is necessary to complete it. Given that it typically takes at least a week and often longer for CFIUS to accept a formally filed joint voluntary notice, and that CFIUS remains understaffed—especially in relation to the likely

increase in submissions due to implementation of the pilot program—the declaration process may take substantially longer than 30 days.

As required by FIRRMA, upon receiving a declaration, CFIUS may take one of four actions. It may (1) request that the parties to the transaction file a full joint voluntary notice; (2) inform the parties to the transaction that CFIUS is not able to complete action unless a joint voluntary notice is submitted; (3) initiate a unilateral review of the transaction; or (4) notify the parties in writing that CFIUS has concluded all action under section 721 with respect to the transaction (i.e., CFIUS has cleared the transaction). Notably, CFIUS may take any of these actions upon receiving a declaration, meaning that CFIUS may refer complex cases to full review or clear easy transactions sooner than 30 days. Thus, if implemented efficiently, declarations could empower CFIUS to filter the transactions of interest into full review while quickly disposing of transactions that clearly would not present national security concerns.

Contents of Declarations

The interim rule sets forth the information required to be included in declarations. This includes information regarding the investor and its owners, the pilot program US business, and the transaction itself, all of the sort that would be required in a full notice. Some information required in a full notice is not required in a declaration, such as personal identifier information for officers and directors of the investor and its owners. Other information requirements, however, are specific to a declaration, including:

- All sources of financing for the transaction;
- Whether the pilot program US business has multiple classes of ownership;
- A statement and explanation about the rights that the foreign person will acquire with respect to the pilot program US business;
- Whether the pilot program US business has had any US Government contracts (including subcontracts) within the past three years, or within the past ten years if the contract included access to personally identifiable information of US Government personnel;
- Whether the pilot program US business has received any grants or funding from the Department of Defense or Energy, or has collaborated on any defense or energy program or product involving any critical technologies or pilot program industries within the past five years;
- Whether the pilot program US business has participated in a Defense Production Act Title III Program within the past seven years; and
- Whether the pilot program US business, the foreign investor, or any parent or subsidiary of the foreign investor has been convicted in the last ten years of a crime in any jurisdiction.

These new information requirements reflect issues—such as personal information, government funding, and compliance with laws—that have become increasingly relevant to CFIUS’s national security reviews in recent years. We expect this information will be required for all notices under the forthcoming FIRRMA implementing regulations.

Penalties

As noted above, the interim rule provides that any person who fails to comply with the mandatory declaration requirements under the pilot program may be liable for a civil penalty **up to the value of the transaction**. It remains to be seen how aggressively CFIUS will pursue penalties under the pilot program, both in terms of frequency of enforcement and the size of penalties imposed. We note, however, that CFIUS has imposed penalties for material breach of mitigation, so from an administrative perspective CFIUS has the requisite internal procedures to levy penalties for violations.

Additional Investments and Acquisitions of Rights May Be Subject to CFIUS Review

Prior to the pilot program, when CFIUS concluded action on a covered transaction (all of which were “control” transactions submitted by full notice), both the notified transaction and any subsequent acquisition by the foreign person of an additional interest in the US business received “safe harbor,” meaning that except in very limited circumstances the later transaction could not be reviewed by CFIUS or the President. With the pilot program’s introduction of reviews of non-controlling pilot program covered investments and an abbreviated declaration process, CFIUS has elected not to extend this safe harbor to subsequent acquisitions of interests when (1) CFIUS concludes action on a pilot program covered transaction (whether a controlling or non-controlling investment) by declaration, or (2) CFIUS concludes action on a non-controlling “pilot program covered investment” through a full notice. Control transactions reviewed on the basis of a full notice, even when involving a pilot program US business, will continue to receive the safe harbor for any subsequent acquisition of interest in that US business by the foreign person.

In addition, even if CFIUS has concluded action on a pilot program covered investment (whether by declaration or full notice), any incremental investment that involves a new Covered Investment Right would be deemed a new pilot program covered investment subject to a mandatory declaration. Thus, parties that are structuring multi-phase investments or that later agree to additional investments may be required to submit multiple mandatory declarations.

Comments

The interim rule is effective without a notice and comment period, but comments may be submitted on the pilot program regulations through November 10, 2018. The discussion accompanying the pilot program regulations states that comments will be considered and addressed in the process of promulgating any final rule. White & Case intends to comment on the interim rule.

In addition to the interim rule regarding the pilot program, the Treasury Department has issued an interim rule [updating](#) the CFIUS regulations to address the immediately effective provisions of FIRRMA. Although most of these updates were straightforward and expected, there was a notable new regulation with respect to the timing of a CFIUS investigation. FIRRMA allows CFIUS to extend an investigation one time by 15 days in “extraordinary circumstances”. The new regulation defines “extraordinary circumstances” to mean “circumstances for which extending an investigation is necessary and the appropriate course of action due to a force majeure event or to protect the national security of the United States”. This broad language appears to afford CFIUS substantial discretion in invoking the extension, which it may well do in complex transactions requiring extra time for investigation or mitigation negotiations. The extra 15 days should now be factored into CFIUS-related timelines for transaction planning.

We will continue to monitor CFIUS-related developments closely and provide updates as appropriate, including with respect to this and any future pilot programs.

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Pilot Program Industries

Aircraft Manufacturing

NAICS Code: 336411

Aircraft Engine and Engine Parts Manufacturing

NAICS Code: 336412

Alumina Refining and Primary Aluminum Production

NAICS Code: 331313

Ball and Roller Bearing Manufacturing

NAICS Code: 332991

Computer Storage Device Manufacturing

NAICS Code: 334112

Electronic Computer Manufacturing

NAICS Code: 334111

Guided Missile and Space Vehicle Manufacturing

NAICS Code: 336414

Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing

NAICS Code: 336415

Military Armored Vehicle, Tank, and Tank Component Manufacturing

NAICS Code: 336992

Nuclear Electric Power Generation

NAICS Code: 221113

Optical Instrument and Lens Manufacturing

NAICS Code: 333314

Other Basic Inorganic Chemical Manufacturing

NAICS Code: 325180

Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing

NAICS Code: 336419

Petrochemical Manufacturing

NAICS Code: 325110

Powder Metallurgy Part Manufacturing

NAICS Code: 332117

Power, Distribution, and Specialty Transformer Manufacturing

NAICS Code: 335311

Primary Battery Manufacturing

NAICS Code: 335912

Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing

NAICS Code: 334220

Research and Development in Nanotechnology

NAICS Code: 541713

Research and Development in Biotechnology (except Nanobiotechnology)
NAICS Code: 541714

Secondary Smelting and Alloying of Aluminum
NAICS Code: 331314

Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing
NAICS Code: 334511

Semiconductor and Related Device Manufacturing
NAICS Code: 334413

Semiconductor Machinery Manufacturing
NAICS Code: 333242

Storage Battery Manufacturing
NAICS Code: 335911

Telephone Apparatus Manufacturing
NAICS Code: 334210

Turbine and Turbine Generator Set Units Manufacturing
NAICS Code: 333611