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CFIUS Pilot Program: Immediate Implications for Investors and Investment Targets

On October 10, 2018, the U.S. Department of the Treasury issued temporary regulations—a “pilot program”—to implement certain provisions of the Foreign Investment Risk Review Modernization Act (“FIRRMA”), signed into law by President Donald Trump on August 13, 2018.¹ Among other things, FIRRMA expanded the jurisdiction of the Committee on Foreign Investment in the United States (“CFIUS” or the “Committee”) to include new categories of covered transactions and authorized CFIUS to make certain filings mandatory.

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The announcement of the October 10 pilot program represents a dramatic and rapid assertion by CFIUS of new authority granted to it under FIRRMA. Under the pilot program, non-controlling foreign investments in certain U.S. industries (electronics, chemical, and semiconductor manufacturing, and research and development in biotechnology, among others)—which, prior to FIRRMA, were outside the scope of the Committee’s jurisdiction—will be subject to *mandatory* CFIUS notification (at risk of significant penalty). As detailed below, the pilot program may have immediate consequences for active transactions that have not yet progressed to the signing stage.

I. Overview of CFIUS and FIRRMA

CFIUS is an interagency committee with authority to review foreign investments in the United States. The Committee received authority to review foreign transactions following passage of the Exon-Florio Amendment, 50 U.S.C. § 2170, which amended Section 721 of the Defense Production Act of 1950 and granted the President authority to block foreign investments in the United States when “the transaction threatens to impair the national security of the United States.”

CFIUS has authority to review any “covered transaction,” which historically has meant “any transaction . . . by or with any foreign person[] which could result in control of a U.S. business by a foreign person.” 31 C.F.R. § 800.207. FIRRMA—which was motivated by the perception that the existing CFIUS regime was ill-equipped to handle new threats to U.S. national security posed by foreign investment—introduced key reforms to the Committee’s review authority and process:

- **Extended CFIUS’s jurisdiction to any non-passive foreign investment in a U.S. “critical technology” company.** Under FIRRMA, any foreign investment in a U.S. “critical technology” company that is not purely passive is a “covered transaction” subject to CFIUS’s review, even if the foreign investor does not acquire “control” of the U.S. business. Importantly, “passive investment” is narrowly interpreted, and an investment with certain specified rights (*e.g.*, access to non-public technical information, board or board observer rights, etc.) does not qualify.
- **Broadened the definition of “critical technology.”** FIRRMA expanded the definition of critical technology to include not only items covered by the United States Munitions List, items on the Commerce Control List, certain nuclear-related materials, and items covered by the Select Agents and Toxins regulations, 31 C.F.R. § 800.209, but also other emerging and foundational technologies with potential national security implications.

¹ Determination and Temporary Provisions Pertaining to a Pilot Program to Review Certain Transactions Involving Foreign Persons and Critical Technologies (to be codified at 31 C.F.R. § 801), https://home.treasury.gov/system/files/206/FR-2018-22182_1786904.pdf [hereinafter “Interim Rule”].

- **Made certain filings mandatory.** Prior to FIRRMA, the CFIUS regime was entirely voluntary, meaning that the parties to covered transactions were not required to provide notice of the transactions to the Committee. FIRRMA introduced a mandatory filing requirement for certain transactions involving foreign government-affiliated investors, and also authorized CFIUS to develop mandatory filing requirements for certain investments in critical technology companies.
- **Authorized CFIUS to conduct pilot programs to implement aspects of FIRRMA that did not take effect upon enactment.** Certain provisions of FIRRMA, such as the expanded definition of “critical technology,” took effect immediately. Other provisions—including the extension of CFIUS’s jurisdiction to certain non-passive investments—will not take effect until the earlier of (1) the date that is 18 months after enactment, or (2) 30 days after the Secretary of the Treasury certifies that the new regulations and necessary organizational resources called for by the bill are in place. Importantly, section 1727(c) of FIRRMA authorizes CFIUS to conduct “pilot programs” to implement earlier those aspects of FIRRMA that did not take immediate effect.

II. The Pilot Program

The pilot program will take effect on November 10, 2018 and will remain in effect until final regulations implementing FIRRMA are promulgated. The Interim Rule (1) expands CFIUS’s jurisdiction to certain non-passive investments in critical technology companies (“pilot program covered investments”); and (2) introduces a mandatory notification requirement for transactions involving critical technology companies. The Committee implemented the pilot program “expeditiously,” observing that “[d]elaying effectiveness of the interim rule would create an unacceptable risk of erosion of U.S. technological superiority.”²

Expansion of CFIUS’s Jurisdiction

Under the Interim Rule, CFIUS will be authorized to review any “pilot program covered transaction.” The term “pilot program covered transaction” includes (1) transactions in which a foreign person could acquire control of a “pilot program U.S. business”; *and* (2) pilot program covered investments. 31 C.F.R. § 801.210. The former category of transactions—involving controlling investments in U.S. business by foreign persons—is within the scope of CFIUS’s existing jurisdiction. The latter category of transactions—pilot program covered investments—historically has been outside the scope of CFIUS’s jurisdiction. A pilot program covered investment includes any investment, direct or indirect, by a foreign person in an unaffiliated pilot program U.S. business that could *not* result in control by the foreign person of the U.S. business, but that does afford the foreign person:

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

Id. § 801.209.

The term “pilot program U.S. business” includes any U.S. business that produces, designs, tests, manufactures, fabricates or develops a critical technology that is either utilized in connection with the U.S. business’s activity in one or more “pilot program industry” or designed by the U.S. business specifically for use in one or more “pilot program

² *Id.* at 9.

industry.”³ *Id.* § 801.213. These industries include, *inter alia*, aircraft, electronics, military, nuclear, chemical, and semiconductor manufacturing.⁴ According to CFIUS, the list of pilot program industries was “carefully developed by the U.S. government to narrowly scope the pilot program to include only those industries in which the threat of erosion of technological superiority from some foreign direct investment requires immediate action.”⁵

Under the Interim Rule, any transaction involving a non-passive foreign investment in one of the industries covered by the pilot program is now subject to CFIUS’s jurisdiction. 31 C.F.R. § 801.302. This includes, for example, a 4% investment that grants board observer rights, as well as an increase from a 4% to 9% investment that grants access to material nonpublic technical information. *Id.*

The Interim Rule sets forth three noteworthy exceptions:

- *First*, a transaction is not a pilot program covered transaction if (1) the U.S. business does not deal in critical technology, even if it is in a pilot program industry, (2) the transaction does not afford the foreign investor either control rights or any of the rights set forth in § 801.209, or (3) the U.S. business is not in a pilot program industry, regardless of the technology it produces. *Id.* § 801.303.
- *Second*, an indirect investment by a foreign person in a pilot program U.S. business through an investment fund that affords the foreign person membership as a limited partner on the equivalent of an advisory board does not qualify as a pilot program covered transaction if the foreign person is not the general partner and has no control rights. *Id.* § 801.304.
- *Third*, no investment involving air carriers holding a certificate issued under 49 U.S.C. § 41102 shall qualify.

Mandatory Filing Requirement

The parties to every pilot program covered transaction must make a filing with CFIUS, marking the first time in the Committee’s history that a filing has been mandatory. The parties have the option of submitting (1) a joint voluntary notice under existing CFIUS rules, 31 C.F.R. §§ 800.401, 402; or (2) an abbreviated declaration. *Id.* § 801.401(a), (b). Parties to pilot program covered transactions must file either an abbreviated declaration or a voluntary notice on

³ The term “pilot program industry” includes any company in one of 27 industries, as defined by their North American Industry Classification System (“NAICS”) code. *Id.* § 801.212; *Id.* § 801 Annex A.

⁴ The complete list includes: 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); and Turbine and Turbine Generator Set Units Manufacturing (NAICS Code 333611). 31 C.F.R. § 801 Annex A.

⁵ Interim Rule at 9.

November 10, or promptly thereafter, if the completion date of the transaction is between November 10 and December 25, 2018, and within 45 days before the completion of the transaction otherwise. *Id.* § 801.401(c)(2).

The contents of the abbreviated declaration—which, pursuant to FIRRMA, should “not generally exceed 5 pages in length” but which in practice may prove to be longer—must nevertheless include a significant amount of information, including a description of the transaction, a statement of the basis for the transaction being deemed a pilot program covered transaction, information about the U.S. business (including its industry, technology, and U.S. government contacts), and information about the foreign person (including its ownership and any foreign government connections). *Id.* § 801.403.⁶

Abbreviated declarations will undergo a 30-day review period. *Id.* § 801.404. During the 30-day review period, all inquiries from CFIUS must be answered within two business days or the Committee will reject the declaration. *Id.* § 801.406(a)(3). At the conclusion of the 30-day review period, CFIUS may (1) request that the parties file a full, joint voluntary notice; (2) indicate that CFIUS is not able to complete action on the basis of the declaration and invite further correspondence; (3) initiate an investigation of the transaction; or (4) clear the transaction. *Id.* § 801.407.

Underscoring the mandatory nature of the filing, the Interim Rule incorporates a penalty provision. Any person who fails to comply with the requirements of the pilot program to file either a joint voluntary notice or an abbreviated declaration may face a civil penalty “not to exceed the value of the pilot program covered transaction.” *Id.* § 801.409(a).

III. Immediate Implications

Significant Increase in CFIUS Filings

As an initial matter, the Interim Rule will significantly expand the number and scope of transactions subject to CFIUS review. Notwithstanding that the Interim Rule characterizes the definition of “pilot program U.S. business” as “narrowly scoped,” the list of pilot program industries is expansive.⁷ In addition, the definition of “critical technologies,” as recently expanded by FIRRMA, is (purposefully) broad and accords CFIUS considerable discretion to determine that a particular transaction implicates “critical technology” and, therefore, may pose a risk to U.S. national security.⁸ The breadth of these definitions—in conjunction with the introduction of a mandatory filing requirement, backed by a daunting penalty mechanism, and a lack of post-FIRRMA precedent—is likely to result in a significant and immediate increase in CFIUS filings. There is in particular likely to be considerable urgency over the next month for a certain subset of transactions, as any *unsigned* transaction—*see infra*—currently scheduled to close between November 10 and December 25 must be reported by “November 10, 2018, or promptly thereafter[.]” 31 C.F.R. § 800.401(c)(1).

Deterrence of Foreign Investments

The introduction of a mandatory filing requirement foreseeably will deter foreign investment in companies that are—or arguably may be construed as—critical technology companies. The compulsory disclosure of information regarding the foreign investor, as well as uncertainty regarding the scope (and attendant costs) of the abbreviated declaration process,

⁶ Should the parties choose to file a joint voluntary notice, the parties must include similar information regarding why the transaction is a pilot program covered transaction, in addition to the information that is ordinarily required. 31 C.F.R. § 800.503.

⁷ Interim Rule at 13.

⁸ “Critical technologies” previously was defined to include items covered by the United States Munitions List, items on the Commerce Control List, certain nuclear-related materials, and items covered by the Select Agents and Toxins regulations. 31 C.F.R. § 800.209. Pursuant to FIRRMA, the term now also includes “[o]ther emerging technologies that could be essential for maintaining or increasing the technological advantage of the United States over countries of special concern with respect to national defense, intelligence, or other areas of national security, or gaining such an advantage over such countries in areas where such an advantage may not currently exist.”

inevitably will alter the CFIUS risk calculus for many foreign investors. Consistent with FIRRMA's overarching goals, the consequences are likely to be felt most acutely by (1) foreign investors with government affiliations, for which the disclosure requirement may be a significant deterrent; and (2) early stage investors, for which the uncertainty and added costs associated with the abbreviated declaration process may render such investments cost-prohibitive.

The Pilot Program Will Affect Active Transactions

The Interim Rule “do[es] not apply to [1] transactions for which the completion date is prior to the pilot program effective date, or [2] transactions for which the parties have executed a binding written agreement or other document establishing the material terms of the transaction prior to October 11, 2018.”⁹ As the pre-investment due diligence process frequently can extend weeks, months, or even years, there is a significant volume of transactions—including both new investments and increases in existing equity or control rights—that now will be subject to a mandatory CFIUS filing requirement. As a result, parties to active transactions are likely to incur new costs that, in some cases, may undermine the original investment thesis. Relatedly, prospective investors may be required to re-assess and, in some cases, overhaul their investment pipelines, to account for the new jurisdictional standard.

The Changes Are Not Final

As its name suggests, the pilot program is not permanent. The Interim Rule states that:

The scope, procedures, and terms used in the pilot program are specific to the pilot program and subject to change in the proposed final rule implementing FIRRMA. . . . [T]he pilot program implemented through these regulations will end no later than March 5, 2020, the date that is 570 days after the enactment of FIRRMA. These regulations will be amended, replaced, or removed no later than the date on which the pilot program ends.¹⁰

As a result, in addition to re-assessing existing opportunities, investors must continue to follow FIRRMA implementation developments, which may necessitate further revisions to investment and due diligence protocols (the timing of which is relatively uncertain).

IV. Conclusion

FIRRMA represented the most significant effort to revise the CFIUS process in more than a decade. The U.S. Department of the Treasury's announcement of the pilot program signals that CFIUS intends to quickly assert its new authority under the law to restrict certain types of foreign investment in the United States. The changes introduced by the Interim Rule are significant, and almost immediately applicable. Accordingly, dealmakers would be well advised to assess the applicability of the pilot program to pending and future transactions.

⁹ Interim Rule at 11.

¹⁰ *Id.* at 10-11.