CLEARY GOTTLIEB

NEW YORK WASHINGTON PARIS BRUSSELS LONDON MOSCOW FRANKFURT COLOGNE ROME MILAN HONG KONG BEIJING

Treasury Proposes Changes to the Regulations Governing Exon-Florio "National Security" Reviews of Foreign Investment in the United States

Washington, DC
April 22, 2008

The Department of the Treasury ("Treasury") yesterday issued a proposed rule (the "Proposed Rule") amending its regulations implementing the Exon-Florio amendments to the Defense Production Act of 1950 (50 U.S.C. App. § 2170) (the "Exon-Florio Provision"), as recently amended by the Foreign Investment and National Security Act of 2007 ("FINSA").[1] The good news for foreign acquirors is that the Proposed Rule – the most significant amendment to the regulations since their initial promulgation in 1991 – does not go as far as some had feared in expanding the review of foreign acquisitions of U.S. businesses by the Committee on Foreign Investment in the United States ("CFIUS"). Notification remains voluntary, only acquisitions of "control" are subject to notification, and not every acquisition of control will raise national security issues. Some of the recent alarmist predictions of greatly expanded CFIUS reviews have been overblown.

However, while the Proposed Rule retains the essential structure of current CFIUS reviews, it also expands the scope and nature of such reviews in limited but important ways. This memorandum provides a detailed synopsis of the most significant changes contained in the Proposed Rule below, but the key considerations for parties to foreign investment transactions in the United States may be summarized as follows:

- The Proposed Rule reaffirms in clear terms that CFIUS notification remains voluntary and that acquisitions of influence short of "control" by a foreign entity is not subject to the Exon-Florio Provision.

- However, the Proposed Rule expands the definition of "control" in two key ways: first, "control" now includes the power to block key corporate decisions as well as the affirmative power to determine the matters in question, and second, the list of key corporate decisions has been significantly expanded to include a number of common

[1] For a detailed discussion of FINSA, see Cleary Gottlieb's alert memo "Congress Tightens Exon-Florio 'National Security' Reviews of Foreign Investment in the United States," July 12, 2007.

minority protection rights. As a result, relatively standard shareholders' and joint venture agreements providing for supermajority voting on fundamental business decisions will result in "control" for purposes of the Exon-Florio Provision. The Proposed Rule also stresses that "control" remains a flexible concept determined in light of all the facts and circumstances (including formal and informal governance arrangements in addition to formal ownership interests) and that there is no bright-line test for whether control exists.

- The definition of "transactions" subject to the Exon-Florio Provision has also been expanded, most notably by including the acquisition of convertible interests that are exercisable by a foreign person without any conditions beyond that person's control other than the passage of time. For example, the acquisition of warrants exercisable in two years (or out-of-the-money options) that, if exercised, would give the holder sufficient votes to block key corporate decisions is an acquisition of control for Exon-Florio purposes. Proxy contests that, if successful, would result in control over a U.S. business and the contribution of an existing U.S. business to a joint venture over which a foreign person can exercise control are also expressly made subject to the Exon-Florio Provision.

- The treatment of lending transactions is not entirely clear. The Proposed Rule clearly states that rights acquired by a lender upon default (for example, a security interest in the shares of a borrower) may only be notified if a default has occurred or is imminent, and the Proposed Rule gives an example in which a requirement in a loan agreement not to dispose of the assets of the borrower (one of the corporate decisions listed in the definition of "control") does not result in control by the lender. However, the Proposed Rule does not explicitly address the treatment of loans including extensive negative pledge clauses of the sort common in merchant banking or private equity transactions requiring lender approval for a wider range of corporate decisions.

- Contrary to recent press reports, the Proposed Rule retains the safe harbor for purely passive investments of less than 10 percent of the voting interest in a U.S. entity, but it stresses two features of the existing safe harbor that are often misunderstood. First, the safe harbor does not apply when any governance rights (*e.g.*, a directorship) are obtained with the equity stake or when the acquiror has an intent to acquire control at a later time. Second (and equally importantly), the fact that an investment falls outside the safe harbor does not automatically mean that it is subject to the Exon-Florio Provision. An acquisition of control is still required.

- The definition of "foreign person" has been expanded to include any entity organized under the laws of a foreign jurisdiction that is more than 50 percent beneficially owned by foreign persons. Although this provision was intended to more clearly capture publicly held foreign companies not controlled by any foreign individual, it has the

perhaps unintended effect of making acquisitions by offshore vehicles (such as limited partnerships) that are controlled by U.S. entities, but more than 50 percent beneficially owned by foreign persons, subject to the Exon-Florio Provision.

- Consistent with the requirements of FINSA, an extended 45-day investigation of acquisitions by entities controlled by foreign governments is not made mandatory; however, a decision that no such investigation is required must be approved at the Deputy Secretary level by the Treasury Department and the lead agency or agencies reviewing a notification.

- The Proposed Rule clarifies the concepts of "critical infrastructure" and "critical technologies" that are the subject of increased CFIUS scrutiny under FINSA. A transaction involves "critical infrastructure" if the incapacity or destruction of the particular assets involved in the transaction would have a debilitating impact on national security – a much narrower definition than many had assumed. "Critical technologies" are defined by reference to certain technologies with military applications regulated under the export control, arms control, or nuclear regulatory laws.

- The information required to be provided in an Exon-Florio notification has been expanded significantly and the timetable for review has become less certain. Notifications now must include details such as market shares and downstream users of the products in question. Consistent with recent CFIUS practice, detailed information on the chain of ownership of the foreign acquiror and personal identifying information of officers and directors of acquiring entities is also required. CFIUS's ability to reject a filing and re-start the 30-day review period has been significantly expanded, most notably by enabling CFIUS to reject a filing at any time if the parties do not respond within two business days to any request for additional information from CFIUS (though CFIUS may agree to extend that deadline). CFIUS now also formally encourages the practice of submitting a draft notification one week in advance of the anticipated official notification date.

- Enforcement of mitigation agreements with CFIUS has been clarified, providing that any material violation of an agreement voids CFIUS approval, may result in civil penalties, and may (if provided in the relevant agreement) require the payment of significant liquidated damages to the government.

- CFIUS continues to believe that notifications pursuant to the Exon-Florio Provision will be relatively rare, estimating that approximately 120 transactions per year will be notified and 12 of those will be subject to in-depth review.

Treasury will hold a public meeting to discuss the Proposed Rule on May 2, 2008. Comments on the Proposed Rule will be due 45 days after its publication in the Federal Register.

A more detailed analysis of the Proposed Rule follows.

DISCUSSION

Under the Exon-Florio Provision, CFIUS may review foreign acquisitions involving U.S. businesses to determine their effect on U.S. "national security". Parties to an acquisition raising potential national security issues can file a voluntary notification with CFIUS, which triggers a review period (initially 30 days, but subject to an additional 45-day investigation period). While notification is voluntary, it may be in the interest of a foreign investor to do so because CFIUS retains the right to self-initiate a review of any acquisition not notified at any point in the future. If CFIUS ultimately determines that national security may be impaired by a proposed acquisition, the acquisition will be made subject to conditions (typically in the form of a "mitigation agreement") or prohibited; if the acquisition was completed before the review, divestiture may be ordered.

This memorandum highlights some of the key changes to the existing CFIUS process contemplated by the Proposed Rule. These changes can be organized under three major topics: (i) the scope of transactions subject to voluntary review under the Exon-Florio Provision; (ii) the procedures for CFIUS review of voluntary notices; and (iii) the information to be included in voluntary notices.

I. Scope of Transactions Subject to the Exon-Florio Provision

A. Definition of "Control"

The Exon-Florio Provision only covers the review of acquisitions that would result in the foreign "control" of certain U.S. businesses, but the statute has always left the definition of "control" to the implementing regulations. The Proposed Rule retains certain key features of the existing regulations' approach to the definition, avoiding any bright-line test (*e.g.*, greater than 50% of outstanding shares) and considering instead "all relevant factors … together in light of their potential impact on a foreign person's ability to determine, direct or decide important matters affecting a company." Such factors include "ownership of a majority or dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means …." Moreover, the Proposed Rule reaffirms the centrality of "control" to the Exon-Florio analysis, emphasizing that while minority interests may in some circumstances confer control, "[a]cquisition of influence falling short of control over a U.S. business is not sufficient to bring a transaction

under [the Exon-Florio Provision]." However, the Proposed Rule also expands the definition of "control" in a number of important ways, providing that the ability to block decisions (including via supermajority voting requirements) is considered control and expanding the list of rights and business decisions that would raise control issues.

1. New Lists of Control Indicia; Negative Control Concepts Included

The Proposed Rule expands the existing concept of "control" in certain key respects. In particular, the list of business decisions identified as indicia of control is broadened to include decisions regarding (i) the sale, pledge, or transfer of any tangible or intangible assets, whether or not in the ordinary course; (ii) reorganization, merger, or dissolution; (iii) the closing, relocation, or substantial alteration of facilities; (iv) major expenditures or investments, debt or equity issuances, dividend payments, or approval of the operating budget; (v) entry into new lines of business; (vi) entry into or termination of material contracts; (vii) treatment of proprietary information; (viii) appointment or dismissal of officers, senior managers, or employees with access to sensitive information; (ix) other decisions of similar import; and (x) amendment of the organizational documents of the entity with respect to any of the foregoing matters.

Crucially, the concept of "control" has also explicitly shifted from positive control (the ability to cause a listed decision to be taken) to negative control (the ability to block the listed decisions), which could capture a wide range of customary minority investor protections often found in shareholders' agreements (subject to limited exceptions detailed below). It also may capture loan agreements with extensive "negative pledge" clauses; the regulations give a specific example of a loan agreement with a clause preventing the borrower from selling or pledging its principal assets and state that such an agreement does not confer control, but it is unclear how CFIUS would treat more extensive restrictions.

The Proposed Rule does identify certain minority protection rights that "shall not in themselves be deemed to confer control over an entity," but the list is quite narrow. The Proposed Rule's list includes the power: (i) to prevent the sale or pledge of all or substantially all of the entity's assets; (ii) to prevent the entity's entry into contracts with majority investors or their affiliates; (iii) to prevent the entity from guaranteeing the obligations of majority investors or their affiliates; (iv) to purchase additional shares to prevent dilution of the investor's *pro rata* interest; and (v) to prevent amendment of the entity's corporate instruments regarding the foregoing items. The Proposed Rule also states that CFIUS will consider, on a case-by-case basis, whether minority shareholder protections other than those specifically listed do not confer control.

2. "10% Safe Harbor" Retained

Significantly, the Proposed Rule also retains the "safe harbor" for foreign investors holding less than 10 percent of the voting interests in an entity "solely for the purpose of investment."[2] The Proposed Rule specifically states that CFIUS will look to the minority rights listed above in ascertaining whether an investment of less than 10 percent is in fact for investment purposes only. However, this additional language notwithstanding, it appears the scope of the safe harbor is intended to be substantively similar to the safe harbor in the existing regulations.

3. Joint Ventures Brought within Control Analysis

The existing regulations currently indicate that a joint venture where each party has a blocking right over the major business decisions of the joint venture is not a transaction potentially subject to CFIUS review. The Proposed Rule removes this exclusion and harmonizes the standard of "control" of joint ventures with the standard used for all other types of transactions.

B. Definition of "Covered Transactions"

Drawing on FINSA, the Proposed Rule introduces a concept of "covered transactions" for defining which transactions are potentially subject to CFIUS review.

1. Certain Asset Acquisitions and Long-Term Leases

The Proposed Rule clarifies that CFIUS will review transactions that are (i) acquisitions of assets that are or could readily be operated as businesses (*e.g.*, branches or operational warehouse facilities that are not separate entities) or (ii) long-term leases under which the lessee makes substantially all business decisions as if it were the owner. However, long-term concession agreements are excluded from the scope of covered transactions where the U.S. business retains a key oversight function and may terminate the agreement or impose other sanctions for breach. In addition, the Proposed Rule continues to exclude start-up or greenfield investments.

[2] Under the Proposed Rule, ownership interests will be held " 'solely for the purpose of investment' if the person holding or acquiring such interests has no plans or intention of exercising control, does not possess or develop any purpose other than investment, and does not take any action inconsistent with acquiring or holding such interests solely for the purpose of investment."

2. Convertible Instruments

The Proposed Rule changes the existing treatment of convertible instruments (*e.g.*, options, warrants, or preferred stock) under the Exon-Florio Provision. Previously, the acquisition of convertible instruments was not treated as an acquisition of the underlying shares unless and until the conversion right was exercised. The Proposed Rule allows CFIUS to treat the acquisition of a convertible instrument as an immediate acquisition of the underlying shares or interests depending on "factors such as whether the date of conversion has been agreed upon by the parties or is within the power of the acquiring entity to determine." Based on examples provided in the Proposed Rule, it appears that convertible instruments exercisable at the discretion of the acquiror (including instruments exercisable at a fixed point in the future) would be effectively counted as exercised in CFIUS's evaluation of a transaction.

C. National Security and Critical Infrastructure

Since the inception of the Exon-Florio Provision, "national security" has been a broad, undefined concept. However, in the past several years, CFIUS has increasingly considered "critical infrastructure" – *e.g.*, energy, telecommunications, transportation, and similar businesses – as part of "national security," a trend codified in FINSA. Transactions involving critical infrastructure are now subject to heightened scrutiny under FINSA and the Proposed Rule. There has been considerable uncertainty regarding the breadth of the "critical infrastructure" concept, but the Proposed Rule provides a definition that goes some way toward clarifying and narrowing the concept. The Proposed Rule clarifies that a transaction only involves "critical infrastructure" if the particular assets to be acquired in the acquisition under review involve "systems and assets, whether physical or virtual, so vital to the United States" that their incapacity or destruction "would have a debilitating impact on national security." This definition, by focusing on the importance of the actual assets being transferred rather than the general importance of the industry or class of assets and setting a relatively high bar for criticality, may help narrow a broad concept left largely undefined in FINSA.

II. CFIUS Procedures

The Proposed Rule formalizes the current practice of engaging in pre-notice consultation with the CFIUS Staff Chairperson and, where appropriate, providing an advance notice. The Proposed Rule encourages such consultations and suggests that ordinarily a draft should be provided five business days ahead of formal filing. In addition, the clock for CFIUS's initial 30-day review will not start running until the first business day after the CFIUS Staff Chairperson determines that the voluntary notice is complete and distributes the notice to the CFIUS agencies, which is to occur "promptly" after filing. The Proposed Rule also substantially expands the circumstances in which CFIUS may reject a

filing that was previously accepted and restart the 30-day initial review upon a new filing, most notably when there is a material change to the transaction or when the parties fail to respond within two business days to any request for additional information from CFIUS (unless CFIUS agrees in writing to extend that period).

The Proposed Rule implements FINSA's provisions regarding the circumstances that will require an in-depth 45-day investigation in a manner largely consistent with current practice. Although FINSA includes a presumption that transactions in which the foreign investor is government-controlled will be subject to an in-depth investigation, in fact FINSA and the Proposed Rule only impose a heightened procedural requirement for terminating a case at the end of the initial 30-day review: the decision not to commence a 45-day investigation because no national security issue is raised must be approved by the Treasury Department and the lead reviewing agency or agencies at the Deputy Secretary level or above. It remains to be seen how this procedural step will be implemented in practice. It is also worth noting that the stricter approval requirement does not apply where CFIUS determines that the transaction is not an acquisition of "control" by the foreign government-controlled entity and therefore not a "covered transaction" subject to review.

Regardless of whether an acquisition involves government-controlled entity, the head of any CFIUS member agency can initiate an in-depth investigation if he or she believes that a transaction threatens to impair the national security, a power also consistent with current practice. In addition, an investigation can be initiated on the recommendation of the lead agency (with the concurrence of CFIUS) or if the transaction involves foreign control of critical infrastructure and CFIUS determines that such control could impair the national security and has not been mitigated by any agreement with the parties.

III. Information to Be Included in Voluntary Notices

The Proposed Rule expands considerably the information required by the existing regulations. Much of the new information is already required by CFIUS in practice or may be prepared in any event in connection with merger control filings, but the additional burden could be substantial in some cases. A number of the requirements are apparently quite sweeping and potentially voluminous for large multinationals, and how they would be implemented in practice is unclear. Under the Proposed Rule, in addition to the information required under existing regulations, the voluntary notice should include:

- Additional information regarding: (i) the ultimate and intermediate parents of the foreign person; (ii) transaction value; (iii) other persons with a role in the transaction, such as financial advisors and lenders; (iv) contracts with and goods supplied directly or indirectly to the government; (v) details of any government ownership of

or rights regarding the foreign person; and (vi) agreements among foreign persons to act in concert.

- Estimated market shares for the primary product and service lines of the acquired U.S. business, together with an explanation of how the estimate was derived, and a list of direct competitors for those product and service lines.

- Any products or services (including research and development) supplied to or on behalf of third parties and rebranded or incorporated into another party's products and the names under which rebranded products and services are sold.

- Information on "critical technologies" produced or traded by the U.S. business, defined by reference to existing regulatory regimes (*e.g.*, defense articles or services under ITAR and various other controlled items) that deal with the sensitive trade or handling of sensitive goods, technology, and services.

- Identification of every license, permit, or authorization issued by the U.S. government to the U.S. business being acquired.

- Descriptions and copies of the cyber security plans that will be used to protect the acquired U.S. business's systems from attack.

- An organization chart showing the foreign acquiror and its parents, affiliates and subsidiaries.

- Deal documentation that includes any terms reflecting matters relating to post-closing control and governance. According to the discussion in the release for the Proposed Rule, "CFIUS reserves the right to reject a voluntary notice in cases in which the deal terms regarding such matters are undecided."

- "Personal identifier information" (*e.g.*, place and date of birth, passport information, dates and nature of prior foreign government or military service) for members of the board of directors and senior company officials of entities in the ownership chain of the foreign acquiror.

- "Business identifier information" for all entities in the chain of control of the acquiror, including both contact details for their headquarters and contact details for each branch of each entity (including all names under which the entity operates).

- A reasoned statement of the parties' views about whether: (i) the acquiror is controlled by a foreign government; (ii) the acquiror is a foreign person; and (iii) the transaction will result in foreign control of a U.S. person.

- Expanded certification language regarding the accuracy and completeness of the voluntary notice and follow-up information. The certifications are to come from a knowledgeable, high-level officer, director or partner who has the authority to bind the organization.

IV. Conclusion

The Proposed Rule retains the basic structure of CFIUS notifications, codifying and clarifying practices that have developed over the years. Moreover, by largely implementing the current practice – and, more importantly, by conspicuously failing to adopt some of the more sweeping requirements some have suggested could or would be implemented – the Proposed Rule will not fundamentally change the nature of the CFIUS review process or the basic calculus of the decision as to whether to submit a voluntary notification. While in recent years it has become clear that national security reviews extend well beyond the defense industry to sectors such as energy, telecommunications, and transportation, the Proposed Rule has not further expanded that scope.

Nevertheless, while the Proposed Rule's updating and clarification of CFIUS's jurisdictional analysis is welcome, it also remains the case that there are few bright lines and little detailed guidance on whether particular transactions should be notified, and balancing the political and administrative risks of notification in particular cases will remain a challenge for foreign acquirors in a broad range of industries outside the defense sector. Although outright prohibitions of transactions appear destined to remain rare, the Proposed Rule signals that the recent evolution of more stringent reviews (particularly of acquisitions by foreign government-controlled entities), more burdensome mitigation agreements, and CFIUS involvement in a variety of "national infrastructure" industries such as telecommunications, energy, and transportation is likely to remain in place (although not to continue expanding to the extremes predicted by some). Certain of the provisions in the Proposed Rule, particularly the treatment of minority protection rights, lender consents, and new filing requirements, could also impose significant practical burdens on parties to cross-border acquisitions if not refined in the final rules.

The issues that will be raised in the public comment period and any changes made in the final regulations, which will not be issued for an indeterminate time after the public comment period, may clarify or mitigate some of these issues or shed additional light on the current state of CFIUS practice. In the meantime, the Proposed Rule serves as a useful guide to CFIUS's current views and practices under the existing regulations.

* * *

Any questions regarding the Exon-Florio Provision or CFIUS review may be discussed with Paul Marquardt, Rick Bidstrup or Nathaniel Stankard in the Washington Office (+1 202 974 1500).

CLEARY GOTTLIEB STEEN & HAMILTON LLP

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax