Recent Revisions to Exon-Florio "National Security" Reviews of Foreign Investment in the United States

Washington, DC
December 22, 2008

On December 22, 2008, new rules issued by the Department of the Treasury ("Treasury") governing national security reviews of foreign acquisitions in the United States by the Committee on Foreign Investment in the United States ("CFIUS") took effect.[1] The Final Rule implements the statutory amendments, enacted as the Foreign Investment and National Security Act of 2007 ("FINSA"), to the law governing such reviews, the Exon-Florio amendment to the Defense Production Act of 1950 (the "Exon-Florio Amendment").[2] The Final Rule is broadly similar to Treasury's April proposals.[3] Furthermore, on December 8, Treasury published guidance (the "Guidance") describing certain factors CFIUS considers in reviewing foreign acquisitions of U.S. businesses that may raise national security concerns.[4] The Final Rule and the Guidance, together with FINSA itself and an executive order revising certain CFIUS procedures issued by the President in January 2008,[5] complete the most significant revisions to the Exon-Florio Amendment and CFIUS reviews in the nearly two decades of their existence.

---

1 73 Fed. Reg. 70,702 (Nov. 21, 2008) (the "Final Rule"). Procedural changes set forth in the Final Rule will apply to transactions notified to CFIUS after December 22, 2008. The changes relating to the scope of covered transactions, however, will not apply where execution of the letter of intent or agreement occurred prior to December 22 (unless the terms of the transaction changed materially), even if the transaction is notified to CFIUS after that date.

2 50 U.S.C. App. § 2170; Pub. L. No. 110-49, 121 Stat. 246 (2007). For a detailed discussion of FINSA, the CFIUS process, and developments in CFIUS practices, see Cleary Gottlieb's alert memo "Congress Tightens Exon-Florio 'National Security' Reviews of Foreign Investment in the United States," July 12, 2007.

3 73 Fed. Reg. 21,868 (April 23, 2008). For a discussion of the proposal, see Cleary Gottlieb's alert memo "Treasury Proposes Changes to the Regulations Governing Exon-Florio "National Security" Reviews of Foreign Investment in the United States," April 22, 2008.

4 73 Fed. Reg. 74,567 (Dec. 8, 2008).

5 Executive Order 13,456, 73 Fed. Reg. 4,677 (Jan. 23, 2008) (the "Executive Order").

Despite the controversy surrounding CFIUS review of a number of high-profile transactions in recent years and the intense debate surrounding the revisions, the fundamentals of the CFIUS process remain largely unchanged. Notification remains voluntary, only acquisitions of "control" are subject to notification and CFIUS review is limited to considerations of "national security." There still are no bright-line standards, and only a relatively small percentage of acquisitions are expected to trigger a second stage of investigation or to require mitigation measures. The Final Rule notes that, from 2005 to 2007, CFIUS "reviewed less than ten percent of foreign transactions in the United States" and "does not expect the changes to the regulations to materially affect the number of transactions that it reviews."

Nonetheless, there are some significant changes to the scope of CFIUS reviews, some changes to recent CFIUS practice, and new guidance to be considered in deciding whether to file a voluntary notification. The following summary highlights the principal considerations for parties to foreign investment transactions in the United States:

- Scope of "Control." Assessment of whether a transaction would give a foreign person "control" of a U.S. business remains a flexible concept determined in light of all the facts and circumstances (including formal and informal governance arrangements, as well as formal ownership interests). However, reflecting recent CFIUS practice, the Final Rule expands the formal definition of "control" to include not only the power to make key corporate decisions, but the power (formal or practical) to block them. The Final Rule also provides an expanded list of factors that generally will reflect control as well as a fairly narrow list of minority protection rights that generally will not be considered to result in "control." New examples accompanying the Final Rule's definition of "control" also clarify some of the ambiguities relating to treatment of non-corporate entities such as limited partnerships.

- Scope of "National Security" and "Critical Infrastructure." CFIUS focuses solely on national security concerns raised by a covered transaction, not on other national interests. CFIUS's recent guidance confirms its practice of using a matrix of the vulnerabilities associated with the assets being acquired and the risks posed by the acquiror in assessing the national security impact. However, CFIUS has considered "national security" to be a broad concept including matters well beyond overtly defense-related transactions, and the statute always included effects on the industrial base and proliferation as part of the analysis. FINSA formally included homeland security in the national security review and added the concept of "critical infrastructure," defined to include any "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security" affected by a particular transaction. CFIUS further

notes that it has reviewed transactions involving the energy sector at all stages in the chain from the exploitation of natural resources to transportation to production and sale, the design and production of advanced technologies, the transportation system, and the financial system.

- Clarification of "Covered Transactions." A "covered transaction" is the term for the basic jurisdictional test: a transaction in which a foreign acquiror gains "control" of a "U.S. business." The treatment of particular types of transactions has been clarified in several significant respects:

    - *Convertible interests.* Acquisitions of convertible interests that are exercisable by a foreign person without any conditions beyond that person's control other than the passage of time are now subject to the Exon-Florio Amendment. For example, an 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 now an acquisition of control, absent any other convertibility conditions.

    - *Proxy contests.* Proxy contests that, if successful, would result in control over a U.S. business are now expressly subject to the Exon-Florio Amendment.

    - *Corporate reorganizations*. The exemption for transactions that did not result in a change in ultimate parent (*e.g.*, a transfer of a U.S. business from one subsidiary to another) has been eliminated, making such transactions subject to the Exon-Florio Amendment (although CFIUS has indicated that such transactions generally raise no issue).

    - *Joint ventures.* Joint ventures are no longer treated differently from other acquisitions. The former exclusion for 50-50 joint ventures has been removed.

    - *Lending transactions.* In addition to reaffirming that a loan is generally not a covered transaction for purposes of the Exon-Florio Amendment, the Final Rule provides that certain standard loan covenants giving the lender negative rights will not be considered to result in control of the borrower "so long as the foreign person does not acquire economic or governance rights in the U.S. business characteristic of an equity investment but not of a loan." Rights acquired by a lender upon default (for example, a security interest in the shares of a borrower) would be subject to CFIUS jurisdiction if a default has occurred or is imminent.

- *Passive minority investments.* The safe harbor from CFIUS review for certain acquisitions of 10 percent or less of the voting securities of a U.S. business has been retained, with emphasis that the investment must be purely "passive" to benefit from the exclusion. For example, the safe harbor does not apply when any governance rights (*e.g.*, a directorship) are obtained with the equity stake or when the acquiror intends to acquire control at a later date. However, the fact that an investment falls outside the safe harbor (either because the percentage interest exceeds 10% or because the investment is not entirely passive) does not automatically subject the transaction to review under the Exon-Florio Amendment; a finding of an acquisition of "control" is still required.

- *Incremental acquisitions.* The Final Rule clarifies that, following favorable action by CFIUS on review of a transaction determined to be a covered acquisition of control, the same foreign person's acquisition of an additional interest in the U.S. business is not subject to CFIUS review. However, an additional interest acquired by a different foreign person may still require review.

- Notification Procedures and Timeline. As a result of significant changes to the procedures and information requirements, preparation of a notification will require additional time and effort, and pre-notice consultations and prompt responses to CFIUS questions will be critical to avoid disrupting transaction timelines.

  - *Review timeline.* The Final Rule expands the ability of CFIUS to reject a filing and re-start the 30-day review period, most notably by enabling CFIUS to reject a filing at any time if the parties do not respond within three 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.

  - *Foreign government transactions.* An extended 45-day investigation of an acquisition by an entity controlled by a foreign government is not mandatory, despite some press reports to the contrary; 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. In practice, foreign government transactions are more likely (but not certain) to undergo extended investigation.

- *Mitigation agreements.* 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. However, the Executive Order raised the bar for imposition of mitigation agreements by stressing that such agreements should only be imposed where existing law does not adequately address a risk and by requiring a written analysis detailing the national security risk and the measures proposed to mitigate it. CFIUS officials have confirmed in public comments that the use of mitigation agreements has declined.

- *Required notification information.* Under the Final Rule and Guidance, the information required to be provided in an Exon-Florio notification has been expanded significantly. Notifications now must include details such as market shares, downstream users of the products of the U.S. business, and detailed information on government contracts and permits held by the acquired business. Consistent with recent CFIUS practice, detailed information on the chain of ownership of the foreign acquiror and substantial, personal identifying information of officers and directors of acquiring entities is also required. In addition, the Guidance reflects the fact that CFIUS often requests information in addition to that required by the regulations, suggesting that such information is best provided in a party's original submission if relevant.

A more detailed analysis of the recent changes and clarifications and their potential implications for foreign acquisitions of U.S. businesses follows.

DISCUSSION

Under the Exon-Florio Amendment, 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 are encouraged to file a voluntary notification with CFIUS, which triggers a 30-day review period that may be extended by an additional 45-day investigation. While notification is voluntary, it may be in the interest of a foreign investor to notify because CFIUS retains the right to self-initiate a review of any acquisition not notified at any point in the future (subject to certain procedural restrictions). If CFIUS concludes that national security would be impaired by a proposed acquisition, the acquisition will be subjected to conditions (typically in the form of a "mitigation agreement" with the acquiring party) or in extraordinary cases prohibited by Presidential order; if the acquisition was completed before the review, the President may order divestiture. Typically, if it appears that CFIUS is unwilling to approve a transaction even with conditions or the conditions are unacceptable to the parties, the notification is withdrawn and the transaction abandoned.

The following discussion describes in greater detail the key changes and clarifications to the CFIUS process contained in the recent statutory and regulatory amendments, organized under three major topics: (i) the scope of transactions subject to voluntary review under the Exon-Florio Amendment; (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 Amendment

A. Definition of "Control"

The Exon-Florio Amendment only subjects foreign acquisitions of "control" over a U.S. business to potential review, but the statute has always left the definition of "control" to the implementing regulations. The Final Rule retains certain key features of the previous regulations' approach to "control", avoiding any bright-line test (*e.g.*, greater than 50% of outstanding shares) and considering instead "all relevant facts and circumstances in light of their potential impact on a person's ability to determine, direct or decide important matters affecting an entity." Such factors include "ownership of a majority or a 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 Final Rule reaffirms the centrality of "control" to the Exon-Florio analysis, emphasizing that while minority interests may in some circumstances confer control, acquisition of influence falling short of control over a U.S. business is not sufficient to bring a transaction under the Exon-Florio Amendment. However, the Final Rule also expands the concept of "control" by indicating that the ability to block certain corporate actions could raise control issues.

1. New Indicia of Control

As noted, "control" is defined as the right of a foreign person to determine "important matters affecting an entity." While no one matter is dispositive, the Final Rule expands the list of "important matters" treated as indicia of control to include the following:

- The sale, lease, mortgage, pledge, or transfer of any tangible or intangible assets, whether or not in the ordinary course;
- Reorganization, merger, or dissolution;
- The closing, relocation, or substantial alteration of facilities;
- Major expenditures or investments, debt or equity issuances, dividend payments, or approval of the operating budget;
- Entry into new lines of business;
- Entry into or termination of material contracts;
- Treatment of proprietary information;
- Appointment or dismissal of officers, senior managers, or employees with access to sensitive information; and
- Amendment of the organizational documents of the entity with respect to any of the foregoing matters.

It remains the case that there is no bright-line percentage ownership test for "control" and that, given the absence of any published precedent binding on CFIUS, it is difficult to provide a definitive answer as to whether control will be found in a particular case. As a practical matter, the control finding may be influenced by CFIUS's substantive view of the transaction (*i.e.*, control is more likely to be found in a transaction that raises national security concerns).

2. Negative Control

The concept of "control" has also expanded to encompass not only positive control (the ability to cause a decision to be taken), as set out in the prior regulations, but also negative control (the ability to block a decision). The prior regulations formally required the ability to affirmatively cause a decision to be taken, although CFIUS's practice evolved to examine transactions at ownership levels where such positive control was

extremely unlikely. CFIUS evaluates control "on a case-by-case basis, considering the level of ownership interest, the rights that emanate from such ownership, other rights held, restrictions on the exercise of such rights, and all other relevant facts and circumstances," so it is not necessary that an investor have a formal legal right to block decisions in order for control to be found.

3. Minority Protection Rights

Negative rights often manifest themselves as minority shareholder rights, and the Final Rule is not intended to subject all such minority investments to potential CFIUS review. The Final Rule identifies certain minority investor protection rights that "shall not in themselves be deemed to confer control over an entity," including the power:

- To prevent the sale or pledge of all or substantially all of the entity's assets or a voluntary filing for bankruptcy or liquidation;
- To prevent the entity's entry into contracts with majority investors or their affiliates;
- To prevent the entity from guaranteeing the obligations of majority investors or their affiliates;
- To purchase additional shares to prevent dilution of the investor's *pro rata* interest;
- To prevent the change of existing legal rights or preference of the stock class held by minority investors; and
- To prevent amendment of the entity's corporate instruments regarding the foregoing items.

The Final Rule also states that CFIUS will consider, on a case-by-case basis, whether minority shareholder protections other than those specifically listed above are consistent with a finding of no control. These additional minority shareholder protections include the power:

- To prevent changes in the capital structure that would dilute or impair minority shareholder rights (including mergers, consolidations, or reorganizations);
- To prevent acquisition or disposition of material assets outside the ordinary course of business;

- To prevent fundamental changes in the business or operational strategy;
- To prevent incursion of substantial indebtedness outside the ordinary course of business;
- To prevent fundamental changes in regulatory, tax or liability status; and
- To prevent amendment of the entity's corporate instruments.

While it remains to be seen how this broader list will be used in practice, it does provide some comfort that such rights should not ordinarily make a minority investor a controlling entity without additional facts.

4. Control of Partnerships and Related Funds

Two examples accompanying the Final Rule's definition of "control" clarify the application of the definition to partnerships, which are common in private equity and other alternative investment contexts. Where a general partner has sole authority over important matters affecting the partnership (and, if applicable, any fund operated by the partnership), only the general partner has "control," notwithstanding the large percentage equity interests held by the limited partners. If the limited partners have certain control rights, however, such as the authority to veto major investments or to choose a fund's representatives on the boards of the portfolio companies, the limited partners as well as the general partner may have "control" under the Final Rule.

B. Examples of Particular Transactions

The basic definition of a "covered transaction" potentially subject to CFIUS review is any acquisition of control of a U.S. business by a foreign person. However, the treatment of transactions that are not straightforward acquisitions is not always clear, nor is the "control" definition. The Final Rule therefore provides guidance on a number of transaction structures that are or are not "covered transactions."

1. Convertible Instruments and Proxy Contests

The Final Rule changes the existing treatment of convertible instruments (*e.g.*, options, warrants, or preferred stock) under the Exon-Florio Amendment. 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 Final Rule allows CFIUS to treat the acquisition of a convertible instrument as an immediate acquisition of the underlying shares or interests where "the results of conversion are reasonably ascertainable [*i.e.*, the amount of voting interest and rights upon conversion] and the conversion is in the

near future." However, if the conversion is "speculative or remote," CFIUS will defer consideration until "conversion of the instruments becomes imminent." Based on examples provided in the Final 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.

2. Proxy Contests

The Final Rule adds proxy contests to the categories of "transactions" that could result in control of a U.S. business. Thus, even a shareholder owning only a fraction of a percent of a U.S. company could be deemed to acquire control if it mounted a successful proxy contest. The Final Rule gives no detail on the sorts of proxy solicitations that would be considered to be potential acquisitions of control, and it remains to be seen how in practice CFIUS will treat, for example, significant shareholders' resolutions or the nomination of minority slates of directors.

3. Joint Ventures

The Final Rule removes the exclusion in the current regulations for a joint venture where each party has a blocking right over the major business decisions of the joint venture and thus neither has affirmative control (*e.g.*, as may be the case in a 50-50 joint venture where each party has veto power over all of the matters effecting the joint venture). Instead, the treatment of joint ventures is harmonized with the treatment of all other types of transactions.

4. Lending Transactions

The Final Rule clarifies that loans are not "transactions" unless "the foreign person acquires economic or governance rights . . . characteristic of an equity investment, but not of a loan." Absent such a finding, typical loan covenants giving the lender negative rights over certain decisions of the borrower do not implicate CFIUS jurisdiction. However, a loan or other financing arrangement whereby the lender acquires an interest in profits, a right to appoint directors, or other financial or governance rights characteristic of equity investments may constitute a covered transaction.

In addition, in the case of default, a lender's acquisition of equity or assets via foreclosure on its security interest is reviewable under the Exon-Florio Amendment. The Final Rule specifies that CFIUS "will accept a [voluntary notification] when default becomes imminent or some 'other condition' arises that would result in a 'significant possibility' that the foreign lender may obtain control of the U.S. business." To address the potential uncertainty regarding the enforceability of security interests that post-facto review could create, the Final Rule gives the foreign lender time to dispose of collateral in cases

raising national security concerns, provided there are arrangements to transfer management decisions or day-to-day control over the U.S. business to U.S. nationals, without risking a suspension or prohibition order under the Exon-Florio Amendment.

5. Passive Investments

The Final Rule clarifies the "safe harbor" for foreign investors holding less than 10 percent of the voting interests in an entity "solely for the purpose of passive investment."[6] The language was revised to add the word "passive" and emphasize that the safe harbor does not provide absolute immunity for investments of less than ten percent. The Final Rule specifically states that CFIUS will look to any governance rights or board representation held by the investor in determining whether an investment of less than 10 percent is in fact for passive investment purposes only.

6. Certain Asset Acquisitions and Long-Term Leases

The Final 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 legal entities) or (ii) long-term leases "under which a lessee makes substantially all business decisions concerning the operation of a leased entity, 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 Final Rule continues to exclude start-up or "greenfield" investments and acquisitions of assets that do not amount to an operational business.

7. Incremental Acquisitions

The Final Rule specifies that acquisition by the same foreign person of an additional interest in a U.S. business, where the earlier transaction was a covered transaction that completed CFIUS review following notification, is not a new covered transaction. In other words, if an earlier transaction was found to be an acquisition of "control" and cleared, subsequent transactions need not be notified; however, if (as sometimes happens) a minority investment was found not to be an acquisition of control future transactions would still be subject to CFIUS review.

---

[6] Under the Final Rule, ownership interests will be held "solely for the purpose of passive investment if the person holding or acquiring such interests does not plan or intend to exercise control, does not possess or develop any purpose other than passive investment, and does not take any action inconsistent with holding or acquiring such interests solely for the purpose of passive investment."

8. Corporate Reorganizations

Under the previous regulations, transactions in which the ultimate parent of the U.S. business did not change (*e.g.*, a transfer of a U.S. business from one foreign subsidiary of a foreign parent to another) were not "covered transactions" subject to CFIUS review. This exemption has been eliminated in the Final Rule. However, the Final Rule also indicates that such a transaction is unlikely to raise a national security concern except in unusual circumstances.

C. Analysis of "National Security"

The Guidance emphasizes that CFIUS focuses solely on any genuine national security concerns raised by a covered transaction, not on other national interests. "National security" deliberately is not defined in FINSA or the Final Rule (other than by indicating that it includes homeland security and control of critical infrastructure), and CFIUS is left with considerable discretion to determine what may threaten national security. To structure that review, CFIUS engages in a two-stage analysis of vulnerability and threat. In the first step, it (1) identifies all national security considerations, including but not limited to those listed in the Exon-Florio Amendment and other national security laws, in order to (2) assess whether the nature of the U.S. business, or its relationship to a weakness or shortcoming in a system, entity, or structure, creates a vulnerability in U.S. national security. (*i.e.*, whether a foreign person in control of the acquired business could take action that threatens to impair U.S. national security). In the second step of the analysis, CFIUS assesses whether the particular foreign acquiror poses a threat (*i.e.*, has the capability or intention to exploit or cause harm).

1. Types of Transactions Raising National Security Considerations

The Guidance provides an illustrative, non-exhaustive list of certain types of transactions that CFIUS has, based on its previous experience, determined may involve national security considerations. The Guidance emphasizes that the list does not identify the types of transactions that pose national security risk (and hence would be subject to modification or blocking), but rather those that have simply presented national security considerations, and should not be interpreted to suggest that the U.S. Government encourages or discourages the types of transactions it describes. It also emphasizes that CFIUS review is not determined solely by industry and that there are no sectors that automatically raise (or do not raise) national security considerations.

(a) Considerations Arising from the Nature of the U.S. Business

Although CFIUS clearly states that it does not automatically focus on (or exempt) particular business sectors, the Guidance identifies the following sectors in which transactions have raised national security considerations:

- U.S. businesses that provide products and services to agencies of the U.S. Government and state and local authorities, including businesses in the "defense, security, and national security-related law enforcement sectors";

- U.S. businesses focused on weapons and munitions manufacturing, aerospace, and radar systems;

- U.S. businesses in the "energy sector at various stages of the value chain" or involving "major energy assets" (*e.g.*, exploitation, transportation, and conversion of natural resources, as well as power production);

- U.S. businesses related to the national transportation system (*e.g.*, maritime shipping, port terminal operations, aviation maintenance);

- U.S. businesses that could "significantly and directly affect the U.S. financial system";

- U.S. businesses engaged in the "production of certain types of advanced technologies that may be useful in defending, or in seeking to impair, U.S. national security" or certain information technologies that could leave a U.S. Government agency vulnerable to sabotage or espionage (*e.g.*, semiconductors, cryptography, data protection, internet security, network intrusion detection); and

- U.S. businesses involving technology, goods, software, or services that are subject to U.S. export controls.

Transactions in these sectors are perhaps more likely to raise national security issues, but it is still important to look at the particular transaction. For example, the acquisition of a small regional bank is unlikely to raise national security issues, even if the acquisition of a major institution with an important role in national financial systems might.

(b) Considerations Arising from Foreign Government Control

The Guidance notes that, while a foreign government control is "clearly a national security factor to be considered, the fact that a transaction is a foreign government-controlled transaction does not, in itself, mean that it poses national security risk." It emphasizes that CFIUS has reviewed and concluded action on numerous foreign-government-controlled transactions, determining that there were no unresolved national security concerns. In reviewing transactions involving a government-controlled investor, CFIUS considers, among all other relevant facts and circumstances:

- The relevant country's record on non-proliferation, cooperation with U.S. counterterrorism efforts, and other national security-related matters;
- The record or intent to terminate contracts between the acquired business and U.S. Government agencies;
- The extent to which the basic investment management policies of the investor require investment decisions to be based solely on commercial grounds;
- The degree to which, in practice, the investor's management and investment decisions are exercised independently from the controlling government, including whether governance structures are in place to ensure independence;
- The degree of transparency and disclosure of the purpose, investment objectives, institutional arrangements, and financial information of the investor; and
- The degree to which the investor complies with applicable regulatory and disclosure requirements of the countries in which they invest.

The U.S. Treasury Department was also heavily involved in promoting and facilitating the recent agreement on the "Santiago Principles" on sovereign wealth fund investment adopted by the International Working Group of Sovereign Wealth Funds under auspices of the IMF, which also emphasize transparency and apolitical investment objectives.[7] One could reasonably anticipate that sovereign wealth funds' adherence to the Santiago Principles will be weighed in CFIUS's evaluation of transactions involving those funds.

[7] International Working Group of Sovereign Wealth Funds, Sovereign Wealth Funds: Generally Accepted Principles and Practices (Oct. 2008).

2. "Critical Infrastructure"

Since the inception of the Exon-Florio Amendment, "national security" has been a broad, undefined concept. However, in the past several years, CFIUS has increasingly considered "critical infrastructure" as part of "national security," a trend codified in FINSA. Transactions involving critical infrastructure are now subject to heightened scrutiny under FINSA and the Final Rule.

There has been considerable uncertainty regarding the breadth of the "critical infrastructure" concept, but the Final Rule provides a definition that goes some way toward clarifying and narrowing the concept by specifying that a transaction only involves "critical infrastructure" if the transaction acquires "a system or asset, whether physical or virtual, so vital to the United States" that its incapacity or destruction "would have a debilitating impact on national security." This definition, by focusing on the importance of the particular 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. The Guidance further emphasizes that while critical infrastructure may be likely to fall within certain sectors – *e.g.*, energy, telecommunications, transportation, and similar businesses – the determination is a case-by-case one focusing on the particular assets being acquired in a transaction.

D. Definition of "Foreign Person"

A covered transaction must involve the acquisition of control of a U.S. business by a "foreign person," and the Final Rule clarifies this term. Previously, "foreign person" was defined as any individual foreign national and any entity over which control was exercised or exercisable by a foreign interest. Although in practice the term was understood to include foreign publicly held companies over which no individual foreign person exercised control, the Final Rule clarifies this by defining a new category of "foreign entity" including entities organized under the laws of a foreign state if either its principal place of business is outside of the U.S. or its equity securities are primarily traded on foreign exchanges. However, such an entity is not a "foreign entity" if "a majority of the equity interest in such entity is ultimately owned by U.S. nationals." Any entity that is, or is controlled by, a foreign national, foreign government, or foreign entity is a "foreign person" whose acquisitions are subject to review under the Exon-Florio Amendment.

II. CFIUS Procedures

The Final Rule makes a number of changes to CFIUS procedures at all stages of its interaction with the parties to a notified transaction.

A. Pre-Notice Consultations

The Final Rule formalizes the current practice of encouraging the parties to a transaction to engage in pre-notice consultation with the CFIUS Staff Chairperson and, where appropriate, to submit a draft notice in advance of the formal filing. The Final Rule suggests that ordinarily a draft should be provided five business days in advance and explicitly extends confidentiality protections to such pre-notice consultations, regardless of whether a notice ultimately is filed.

B. 30-Day Reviews

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 Final 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, this can occur when there is a material change to the transaction or when the parties fail to respond within three business days to any request for additional information from CFIUS (unless CFIUS agrees in writing to extend that period).

C. 45-Day Investigations

The Final 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. FINSA includes a presumption that transactions in which the foreign investor is government-controlled will be subject to an in-depth investigation. However, FINSA and the Final Rule permit the termination of such a case at the end of the initial 30-day review rather than engaging in a 45-day in-depth investigation, subject to a heightened procedural requirement: 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 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. We are aware of several transactions with foreign government-controlled entities in which CFIUS review has in fact been terminated after thirty days.

Regardless of whether an acquisition involves a 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" (rather than "threatens to impair") the national security and has not been mitigated by any agreement with the parties.

These provisions of the Final Rule should be considered in light of the Executive Order, which granted CFIUS discretion as to whether or not to submit a formal report and recommendation for a decision to the President following a 45-day investigation. Previously, the requirement to submit a report and recommendation was mandatory in all investigations. While this permits investigations to be terminated more easily, it also may decrease the barriers to proceeding past the 30-day review stage and increase the prevalence of investigations. For example, CFIUS officials have reported that the number of investigations rose from approximately 5-6 percent of all reviewed transactions in 2006 to over 10 percent in 2008 to date (although part of this increase is likely due to the foreign government provisions described above).

D. Mitigation Agreements

The Final Rule also clarifies enforcement of mitigation agreements with CFIUS, 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.

However, it should be noted that the Executive Order appears to have been intended to diminish somewhat the recent prevalence of mitigation agreements. In particular, a CFIUS member agency seeking a mitigation agreement must now prepare and provide to CFIUS a written statement that: (i) identifies the national security risk posed by the transaction based on factors including the threat, vulnerabilities, and potential consequences; and (ii) sets forth the risk mitigation measures the agency believes are reasonably necessary to address the risk. The member agency may not seek a mitigation agreement without the approval of the full committee.

CFIUS officials report that the use of mitigation agreements is now less frequent, which is consistent with our experience. According to the Treasury Department, approximately 10-15 percent of CFIUS cases had such agreements in 2007, while the corresponding figure this year to date is less than five percent.

III. Information to Be Included in Voluntary Notices

The Final Rule expands considerably the information required by the existing regulations. Some of the new information has already been 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 certain cases. A number of the requirements are quite

sweeping and potentially voluminous for large multinational companies. In addition to the information previously required, the voluntary notice now must include:

- Additional information regarding: (i) the ultimate, immediate 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) certain contracts with and goods and services 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, a description of the methodology used to determine market share, and a list of direct competitors.

- 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.

- "Personal identifier information" (*e.g.*, C.V., 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 all entities in the ownership chain of the foreign acquirer, as well as for any

individuals with an ownership interest of five percent or more in the foreign person or its ultimate parent.

- "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 statement of the parties' opinion 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.

Under the Final Rule, the Staff Chairperson may modify a particular information requirement for a given transaction upon a pre-filing written request showing (i) "extraordinary burden on the parties" and (ii) no impairment of "full and efficient consideration of the transaction."

In addition to the information requirements set forth in the Final Rule, the Guidance states that, in CFIUS's experience, the efficiency of reviews is enhanced when parties to transactions voluntarily provide in their notice additional information that may be relevant, but which is not listed in the Final Rule:

- Whether the U.S. business develops or provides cyber systems, products, or services (*e.g.*, telecommunications or internet systems, process control systems, safety and security systems);

- Whether the U.S. business processes natural resources and material or produces and transports energy; and

- Any required regulatory reviews, ongoing dealings, or outstanding issues that the parties have with other U.S. Government agencies with national security responsibilities.

IV. Conclusion

The Executive Order, Final Rule and Guidance provide a comprehensive revision of the CFIUS process for the first time in a number of years and bring the formal

regulations in line with recent practice in a manner that should enhance the transparency and consistency of the CFIUS process. The refinements of key jurisdictional terms such as "national security," "control" and "covered transaction" are especially useful, and they generally are consistent with Treasury's public pronouncements supporting foreign investment and limiting the role of CFIUS review to true national security concerns.

Although the updating and clarification of CFIUS's jurisdictional analysis is welcome, it remains the case that CFIUS practice is governed by case-by-case assessments, not by bright lines. 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 – there is little change to the basic calculus of the decision as to whether to submit a voluntary notification. 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, including energy, telecommunications, transportation and finance. And from a practical perspective, the required content of a notification has been significantly expanded, and CFIUS also has more authority to adjust the timing of its decisions should the parties not submit timely responses to requests for supplemental information by CFIUS or the lead agency. Accordingly, the time and effort required for preparation, filing and, ultimately, resolution of a CFIUS notice is significantly increased.

* * *

Any questions regarding the Exon-Florio Amendment 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