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PERSPECTIVES

IMPACT OF THE NEW CFIUS PILOT PROGRAMME

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Foreign persons considering investments in the United States beware. Under the Foreign Investment Risk Review Modernization Act (FIRRMA), the Committee on Foreign Investment in the United States (CFIUS) has substantially expanded authority to review, impose conditions on and, if necessary, unwind both controlling and non-controlling investments involving "critical technologies" – including certain passive investments that do not qualify for an exemption.

Filing a minimum of 45 days before closing is now mandatory for certain controlling and non-controlling investments across a broad range of industries and technologies. Failure to comply is punishable by penalties equal to the value of the transaction and forced divestiture. Pre-transaction due diligence is critical.

What happened? – CFIUS reform

Before FIRRMA, CFIUS jurisdiction extended only to investments that could result in foreign "control" of US businesses (i.e., businesses engaged in interstate commerce in the US) and filing with CFIUS was strictly voluntary. CFIUS reviews investments for threats to US national security, and the primary benefit of filing and clearing a transaction through CFIUS was to obtain a safe harbour from post-transaction government action to alter or unwind the transaction on this basis. The primary risk of filing a transaction was CFIUS authority to condition

the safe harbour on transactional "mitigating measures", which could reduce or eliminate the value of the investment. Buyers and targets unwilling to adopt CFIUS mitigating measures generally abandoned transactions. In the rare cases where deal parties refused to accept mitigating measures, CFIUS could recommend to the president that he block the investment or, if already closed, unwind the transaction.

FIRRMA extended CFIUS jurisdiction to non-controlling investments in certain US businesses and directed CFIUS to establish a mandatory filing process for certain investments. CFIUS has begun the process of implementing these new authorities with a pilot programme mandating pre-closing filing and review for controlling and non-controlling investments that involve "critical technologies".

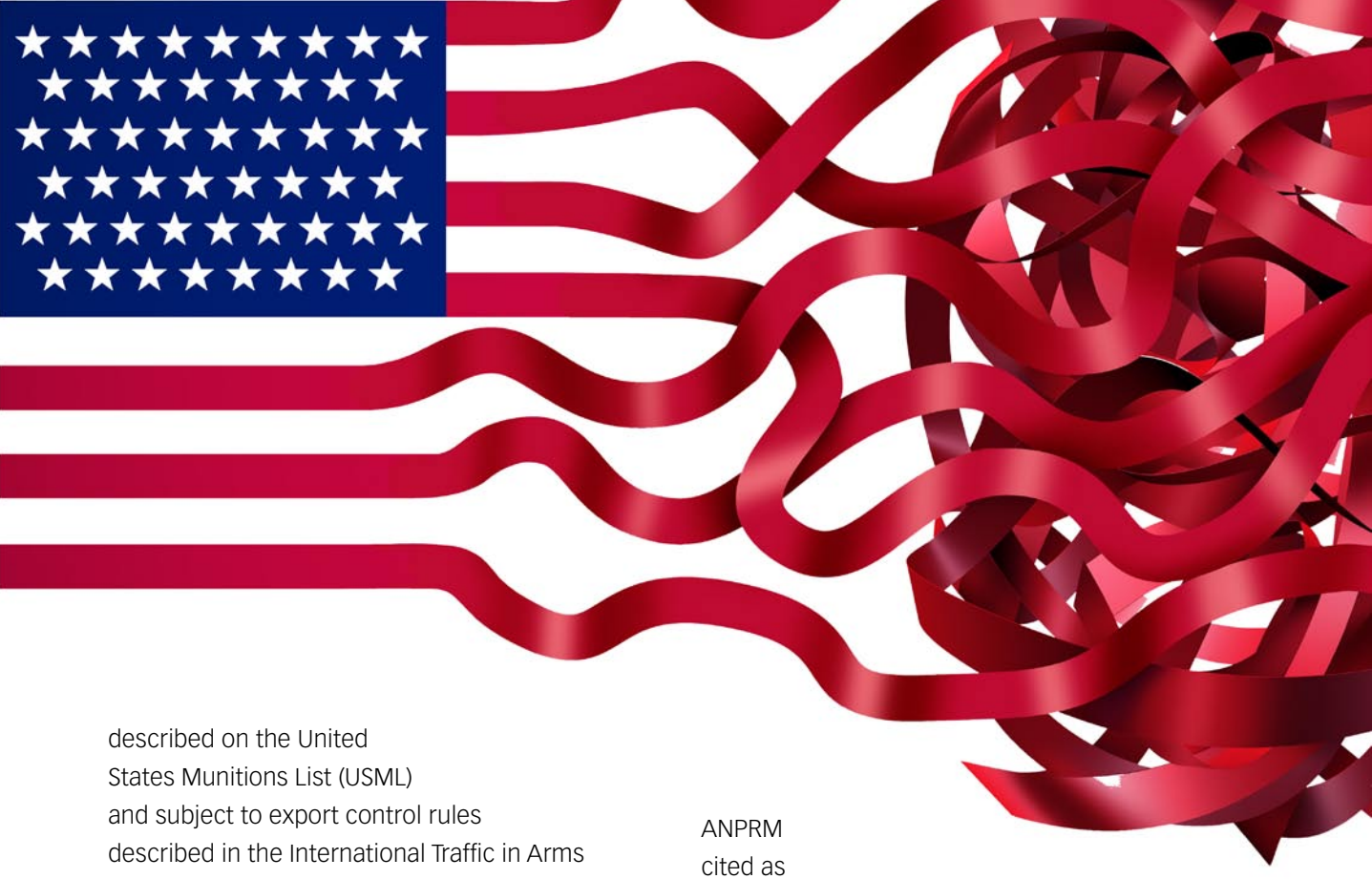
Which investments require mandatory filing under the pilot programme?

As set forth in the pilot programme implementing regulations, an investment constitutes a "Pilot Program Covered Transaction," and must be filed with CFIUS at least 45 days before closing, if the investment satisfies all of the following three conditions outlined below.

First condition. The investment is by a foreign person and would result in control of the target, or, if non-controlling, would endow the investor with: involvement in substantive decision making with respect to "critical technologies", or membership or observer rights on, or the right to appoint a member of, the board of directors, or access to "material nonpublic technical information", which is defined as that which is "not in the public domain" and is "necessary to design, fabricate, develop, test, produce, or manufacture critical technologies, including processes, techniques, or methods".

Importantly, although the expansion to non-controlling investments could capture certain indirect non-US investments through US-managed "investment funds", there is an exemption that permits foreign parties to invest indirectly in a covered business via a fund and even participate as a member of the fund's advisory board, but only if: (i) the fund is managed exclusively by a general partner or equivalent and the foreign investor is not that manager; (ii) neither the foreign investor nor the fund's advisory board can control the fund's or the general manager's investment decisions; (iii) the foreign investor cannot otherwise control the fund, including through rights to select, dismiss, prevent dismissal of, or set compensation for the general manager; and (iv) the foreign investor's participation does not provide the investor with has no access to material nonpublic technical information.

Second condition. The investment is in a US business that produces, designs, tests, manufactures, fabricates or develops a "critical technology". The term "critical technologies" captures a very broad range of technologies, including: (i) defence articles and services



described on the United States Munitions List (USML) and subject to export control rules described in the International Traffic in Arms Regulations (ITAR); (ii) dual use and less sensitive military items described on the Commerce Control List (CCL) and subject to the export control rules described in the Export Administration Regulations (EAR); (iii) select agents (pathogens) and toxins; (iv) items subject to nuclear-related controls relating to assistance to foreign atomic energy activities and exports and imports of nuclear equipment and material; and (v) items that the Department of Commerce identifies as "emerging" or "foundational" technologies.

While the list of emerging and foundational technologies has not yet been determined, on 19 November 2018, Commerce published an advance notice of proposed rulemaking (ANPRM), inviting public comment on the criteria that should be used to define and identify such technologies. The ANPRM cited as general examples of "emerging technologies" those with potential weapons, intelligence collection or terrorist applications, or which could provide the US with a "qualitative military or intelligence advantage".

The ANPRM further provided a list of 14 "representative general categories of technology", specifically: biotechnology, artificial intelligence (AI) and machine learning (ML), position, navigation and timing (PNT), microprocessor technology, advanced computing, data analytics, quantum information and sensing, logistics technology, additive manufacturing, robotics, brain-computer interfaces, hypersonics, advanced materials and advanced surveillance. Importantly, the list will

capture technologies that currently are classified as EAR99 for US export control purposes – a classification that permits the items to be freely exported to most countries in the world – although Commerce has stated that it does not intend to capture technologies that are not currently subject to export controls at all, such as those that fall within the regulatory definition of "fundamental research".

Third condition. The "critical technology" is either designed specifically for use in or actually used in connection with the investment target's activity in one of 27 pilot programme industries that are listed by North American Industry Classification System (NAICS) code in Annex A to the pilot programme interim regulations. That list covers a wide spectrum of industries, including manufacturers of aircraft engines, primary batteries, radio and television broadcasting and wireless communications equipment, semiconductors and optical instruments.

Investors should take note that final rules regarding mandatory filing requirements may differ from those of the pilot programme, and additional pilot programmes may follow and may impose new or different filing obligations.

What must putative investors in pilot programme covered transactions do?

Foreign investors considering investing in pilot programme covered transactions must file (or work with the target to file) the proposed investment with CFIUS at least 45 days before closing. This can be done through the traditional CFIUS notice process or through a new short-form process (not to exceed five pages) called a "declaration". The declaration process is meant to streamline CFIUS review. CFIUS is required to "promptly" notify submitting parties when a declaration is complete (the traditional process gives CFIUS a bit more flexibility in determining when a submission is complete), and has only 30 days to review the declared investment (compared to 45 days under the traditional notice process). However, it is unclear whether this will

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make much difference in practice. Under the declaration process, CFIUS has authority to ask investors to submit traditional, full notices for any investments on which CFIUS is unable to conclude action within the allotted time frame.

Even with the short-form declaration process introduced by the pilot programme, when an investment appears to trigger CFIUS review requirements, investors should factor significant extra time into their transaction timelines. In addition to the time needed to prepare the notice or declaration (traditional CFIUS notice filings typically require three to five weeks to prepare), before the advent of mandatory filings under the pilot programme, even relatively simple transactions could take two to three months to clear the CFIUS process. With the flood of additional transactions requiring review under the pilot programme, CFIUS processing timelines could slip even further.

How can investors protect themselves?

A robust screening process for investments in US businesses is critical. Identifying investments with pilot programme exposure will require accurate identification and classification – against export controls lists and the representative categories of emerging and foundational technologies – of all technologies that the target produces, designs, tests, manufactures, fabricates or develops, as well as a clear understanding of the industries in which the target operates.

Unfortunately, it is often the case that even supposedly sophisticated targets lack the necessary level of awareness regarding export control classification of their technologies, and investors, therefore, should not blindly rely on a target's representations that it does not deal in "critical technologies", but should rather factor into the transaction timeline additional time to review and analyse the target's assets, which may require outside expertise.

Forward-thinking investors should also anticipate and incorporate into their deal documents provisions to neutralise or share the cost of delays in obtained CFIUS clearance (e.g., extended or flexible closing dates) and any required CFIUS mitigation measures. Buyers may structure investments to segregate foreign access to the target's critical technologies or even exclude sensitive assets from the investment altogether. Buyers can also negotiate for provisions that specify acceptable CFIUS mitigation measures, and termination rights beyond such measures.

Investors may also require targets to modify their compliance programme guidelines to reflect the investment, especially if the target has any US government contracts. Investors should evaluate their own CFIUS 'threat' profile, and those in a consortium comprising multiple nationalities may negotiate for staggered closings to account for

heightened scrutiny for investors from countries CFIUS may deem greater threats to US national security. Well-drafted transaction provisions can preserve maximal operational flexibility for all parties if such anticipatory measures become operational only upon affirmative CFIUS action.

The pilot programme raises new compliance challenges for non-US investors, but those who take the time to understand the pilot programme interim rules can work with experienced counsel to adapt to the new regulatory era, and mitigate the associated risk. R&C

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