

Client Alert

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US Treasury Department Issues Draft Rules to Implement Changes to CFIUS Review Process

On April 21, 2008, the US Treasury Department issued long-awaited draft regulations to implement the Foreign Investment and National Security Act of 2007 (FINSAs), the recently enacted law that amended the process by which the Committee on Foreign Investment in the United States (CFIUS) reviews the US national security implications of inbound foreign investments. While the draft regulations retain the fundamental framework under which CFIUS reviews foreign investments, they also make some key changes to the review process. In particular, the draft rules broaden the scope of the transactions potentially subject to the jurisdiction of CFIUS and expand the information that transaction parties must submit to commence the review process. Non-US investors interested in the US market should pay close attention to the new requirements and plan accordingly.

Background

The Exon-Florio Amendment, as recently amended by FINSAs, empowers the US President and his designee, CFIUS—a multi-agency group chaired by the Secretary of the Treasury that includes, among others, the Secretaries of Defense, Homeland Security, State and Commerce and the Attorney General—to review “any merger, acquisition, or takeover . . . by or with

a foreign person which could result in foreign control of any person engaged in interstate commerce in the United States.” Parties with deals subject to CFIUS’s mandate voluntarily notify CFIUS of their proposed transactions, although CFIUS is also authorized to commence reviews on its own. If, through the CFIUS process, the President determines that a transaction impairs US national security, he is empowered to suspend or prohibit the transaction.

A series of recent controversial transactions before CFIUS—notably, the 2006 Dubai Ports World effort to acquire container terminals at US ports—have politicized the CFIUS process and focused significant attention on the review of foreign investments in the United States. In the immediate aftermath of the Dubai Ports World transaction, CFIUS tightened its own procedures, among other things requiring decisions to be made only at the highest levels of the member agencies, referring more cases than ever before to 45-day investigations and increasingly requiring parties to enter into agreements to mitigate national security concerns. In July 2007, the controversy culminated in the enactment of FINSAs, which effectively codified these stricter procedures; the new law took effect in October 2007. (Please see our July 11, 2007 *Client Alert*

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entitled "Congress Passes Legislation To Strengthen Review of Foreign Investments in the United States" for more information about FINSA.) In January 2008, President George W. Bush issued an amended Executive Order implementing FINSA and reaffirming the Treasury Secretary's chairmanship of the CFIUS review process.

FINSA also required the promulgation of implementing regulations by April 21, 2008. The Treasury Department issued its draft regulations on that date. Public comments on the draft regulations are due by June 9, 2008. It is unclear to what extent the Treasury Department will make changes as a result of comments it receives. In the meantime, transaction parties should expect to comply with the draft rules as if they were in effect.

Key Changes in the Draft Regulations

As a general matter, the draft rules leave in place the fundamental framework of the CFIUS review process. Notifications to CFIUS are still voluntary. A foreign investor still must acquire "control" in order for CFIUS to have jurisdiction. Thus, foreign investors that would have notified CFIUS of transactions under the prior regulatory regime will still need to do so. The same timeline still applies—30 days for an initial review, 45 days for an investigation and 15 days for a Presidential determination. The process also remains confidential, except to the extent CFIUS may need to disclose information to Congress or in judicial or administrative proceedings. There is nothing in the draft rules to suggest that transactions that CFIUS would have cleared under the existing rules would not be cleared under the new rules.

Yet, the draft rules expand CFIUS's jurisdiction and the scope of its review in potentially significant ways. If these changes are adopted in the final rules, they will subject to CFIUS review transactions that were not previously

covered and that would not reasonably be considered to confer "control." We discuss several of the key changes below.

Pre-Filing Consultation

The draft regulations strongly encourage transaction parties to consult informally with CFIUS before filing a notice of a specific transaction, and "in appropriate cases" to submit "a draft notice or other appropriate documents" at least five business days before submitting a formal filing. Such informal consultations and "pre-filings" have become common practices in recent years, so it is not surprising that CFIUS has included these practices in the draft rules. Significantly, the draft rules clarify that such consultations and pre-filings will be accorded the same statutory confidentiality as formal filings.

While the draft rules encourage informal consultation, they do not provide any mechanism to obtain a determination that review is *not* necessary in a particular case. To be sure, where a transaction may not necessitate filing, parties could engage in informal consultations with CFIUS to gain some comfort for a decision not to file. But CFIUS has no authority to issue any determination unless the parties submit a complete notice and seek formal CFIUS review. Given the breadth of the draft rules, and the cumbersome information collection requirements for filings, the absence of such a process adds uncertainty.

"Control"

As a threshold matter, for CFIUS to have jurisdiction over a particular foreign investment, the foreign investor must be acquiring "control" over a US business. The draft rules contain an expansive, flexible definition of "control." Rather than a bright-line test, such as a dollar value or percentage-ownership threshold, the draft rules define "control" in "functional terms."

Specifically, the draft rules define “control” as the “power, direct or indirect, whether or not exercised, through the 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, to determine, direct, or decide important matters affecting an entity, in particular, but without limitation, to determine, direct, take, reach, or cause decisions regarding . . . important matters affecting an entity[.]”

The draft rules include a list of 10 such “important matters”:

- 1) The sale, lease, mortgage, pledge or other transfer of any of the principal assets of the entity, whether or not in the ordinary course of business;
- 2) The reorganization, merger or dissolution of the entity;
- 3) The closing, relocation or substantial alteration of the production, operational or research and development facilities of the entity;
- 4) Major expenditures or investments, issuances of equity or debt, or dividend payments by the entity, or approval of the operating budget of the entity;
- 5) The selection of new business lines or ventures that the entity will pursue;
- 6) The entry into, termination or non-fulfillment by the entity of significant contracts;
- 7) The policies or procedures of the entity governing the treatment of proprietary information of the entity;
- 8) The appointment or dismissal of officers or senior managers;
- 9) The appointment or dismissal of employees with access to sensitive information; or
- 10) The amendment of the Articles of Incorporation, constituent agreement or other organizational documents of the entity with respect to the matters described previously.

While the Treasury Department has stated that “all relevant factors are considered together in light of their potential impact on a foreign person’s ability to determine, direct or decide important matters affecting the company,” the proposed definition of “control” is potentially expansive with respect to situations in which the investor has contract rights to cause or prevent only certain specified actions without other attributes of “control.” Indeed, the new definition of “control” appears to consider minority shareholders with nothing more than customary minority shareholder protections as potentially having control. The definition could also encompass debt and other loan agreements that confer typical but extensive rights on the investor or lender.

At the same time, the draft regulations identify a limited list of minority protection rights that “shall not in themselves be deemed to confer control over an entity”:

- 1) The power to prevent the sale or pledge of all or substantially all of the assets of an entity;
- 2) The power to prevent an entity from entering into contracts with majority investors or their affiliates;
- 3) The power to prevent an entity from guaranteeing the obligations of majority investors or their affiliates;
- 4) The power to purchase additional shares to prevent the dilution of an investor’s pro rata interest in an entity in the event that the entity issues additional interests; or
- 5) The power to prevent the amendment of the Articles of Incorporation, constituent agreement or other organizational documents of an entity with respect to the matters described previously.

The draft rules suggest that, on a case-by-case basis, CFIUS may consider other minority shareholder protections as not conferring “control,” but for now the list remains limited.

“Foreign Government-Controlled Transaction”

Under FINSA, foreign government-controlled transactions are subject to a formal 45-day investigation, unless the Secretary of the Treasury and the head of the lead agency assigned to the specific CFIUS review jointly conclude that the transaction will not impair US national security. The draft rules define the term “foreign government” as including not just “national and subnational governments,” but also “individuals acting as non-elected heads of state with governmental responsibilities.” This definition is clearly intended to cover sovereign wealth funds that invest the assets of monarchs or rulers who have not been elected to their roles.

“Foreign Person”

The draft rules expand the definition of the “foreign person” whose acquisition of control triggers CFIUS jurisdiction. The term now includes any “entity organized under the laws of a foreign state in which foreign nationals hold, directly or indirectly, at least 50 percent of the outstanding ownership in an entity.” This definition was intended to refer to entities organized outside of the United States that have substantial foreign ownership, even if that ownership is widely dispersed among unrelated persons. But the definition might also cover offshore investment vehicles, such as those used by private equity investors, that, despite having ultimate US control, are more than 50 percent beneficially owned by foreign persons.

“Critical Technologies” and “Critical Infrastructure”

To provide guidance with respect to the industries of particular concern, CFIUS had been expected to clarify the definitions of the “critical technologies” and “critical infrastructure” over which CFIUS is required to employ a heightened level of scrutiny. The draft

rules specify that “critical technologies” are defense articles or services covered by specified export control laws and regulations and nuclear regulatory restrictions. The draft rules also define “critical infrastructure” as “systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular systems or assets of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security,” substantially incorporating FINSA’s definition without further exposition. Parties should expect CFIUS to continue to accord particular scrutiny to transactions in certain core industries—specifically, agriculture/food, water, public health, emergency services, defense, telecommunications, energy, transportation, banking and finance, chemicals, postal/shipping and information technology.

Applicability to Specific Types of Transactions

Greenfield Investments

As expected (and as appropriate), the draft rules continue to exempt start-up, or “greenfield,” investments.

Covered Transactions

In addition to expanding the threshold concept of “control,” the draft rules appear to apply CFIUS review to transactions beyond previously applicable “mergers, acquisitions, or takeovers.” While the draft rules specifically include as a “transaction” subject to CFIUS review (assuming the “control” test is met) the acquisition of an ownership interest in an entity and a merger or consolidation, the rules also specifically include the acquisition or conversion of “convertible voting instruments of an entity” (presumably, convertible securities that, upon conversion, confer voting rights), the acquisition of proxies from holders of a voting interest in an entity, the

formation of a joint venture involving the contribution of a US business, and a long-term lease under which a lessee makes substantially all business decisions concerning the operation of a lease entity, as if it were the owner.

The inclusion of future interests within the jurisdiction of CFIUS is particularly surprising, as the acquisition of such interests previously had been exempt from review. The draft rules specifically provide that CFIUS will consider an acquisition of “convertible voting instruments”—whether in the form of convertible debt, options, warrants or any other form—to confer control based 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, and whether the amount of voting interests that would be acquired upon conversion can be reasonably determined at the time of the acquisition of the instruments.” Examples in the draft rules suggest that, where convertible instruments are exercisable at the acquiror’s discretion, or after a specified period of time, the acquisition of those instruments could subject the acquiror to CFIUS review (again, subject to meeting the “control” threshold). This definition could subject to the CFIUS process acquisitions of future interests that may not be exercisable for many years.

Acquisitions of 10 Percent or Less “Solely for the Purpose of Investment”

Under the existing rules, passive investments (known as investments “solely for the purpose of investment”) of 10 percent or less of the equity of a business entity were exempt from CFIUS review, and some parties interpreted this exemption as a blanket exemption for all investments of 10 percent or less, regardless whether those investments were passive. The draft rules clarify that the 10 percent safe harbor only applies to transactions that are “solely for the purpose of investment,” a term that means that “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.” The determination whether an acquisition is in fact “solely for the purpose of investment” will be based on “the foreign person’s actions, its negotiation of special rights, or other factors.” In an example, the draft rules illustrate that a nine percent investment with certain contractual rights could confer control. How this safe harbor is interpreted could be critical to investments from sovereign wealth funds and others seeking to structure investments entailing limited governance rights.

Changes to the Filing Process

The draft rules significantly increase the information that parties must provide to CFIUS in their notices. In recent years, CFIUS has required parties to submit some of this information either in conjunction with initial filings or in response to requests for further information about a particular filing. But the draft regulations go much further, creating potentially significant and costly information-gathering burdens on transaction parties.

Among other information, for filings to be accepted and the 30-day review clock to begin running, filings will now be required to include the following information (in addition to the information already required in the current rules with respect to the buyer, seller and nature of the proposed transaction):

- The names of all financial institutions involved in the transaction, including advisors, underwriters or financing sources.
- Information about the immediate parent, the ultimate parent and each intermediate parent of the foreign person (a requirement that may be

more burdensome than it appears, since “parent” is now defined to include not just entities holding at least a 50 percent voting interest, but also entities holding the right to at least 50 percent of the profits, potentially making this a complicated showing for entities with complex ownership structures).

- An organizational chart illustrating all of the entities or individuals above the foreign person that is a party to the transaction, up to the persons having ultimate control, showing the percentage of shares in each link in the ownership chain.
- Estimates of the target’s market share for its primary product or service lines, an explanation of how that estimate was derived and a list of direct competitors.
- Information about all contracts with US government agencies in the past three years.
- Information about any products or services that the target supplies, directly or indirectly, to any US government agency, and any products or services that the target supplies to third parties that it knows are rebranded and incorporated into other products.
- A description and copy of the target’s cyber-security plan.
- Information about the target’s products that are subject to export control laws.
- A list of all licenses, permits or other authorizations granted by any US government agency.
- Information about the extent to which the foreign acquiror is controlled by or acting on behalf of a foreign government.
- “Biographical information” for members of the board of directors, senior management and the ultimate beneficial owners of five percent or more of the foreign person engaged in the transaction and its immediate and ultimate parents.
- With respect to the current board members and senior executives of the immediate acquiror and its ultimate parent, and any other entities in the ownership chain that could exercise control over the US business being acquired, and any natural person having an ownership interest of five percent or more in the ultimate parent of the acquiror, the submission of an extensive list of “personal identifier information,” including full name, business address, country and city of residence, date and place of birth, social security number, national identity number, passport information, and dates and nature of foreign government and military service.
- “Business identifier information” for the parents of the immediate acquiror, including the ultimate parent and any other entities in the ownership chain, disclosing the business name, address, telephone, employer identification number and other information.
- With respect to the foreign person that is a party to the transaction, its immediate parent, the US business that is the subject of the transaction and each entity of which the foreign person is a parent, English-language copies of the annual reports of each such entity—a requirement that presents a potentially significant and costly translation burden.
- Provision of not only a copy of the purchase agreement at issue, but also copies of all documents reflecting post-closing control and governance; significantly, CFIUS reserves the right to reject a voluntary notice where the deal terms regarding such matters are undecided.
- Certifications by both buyer and seller, from a knowledgeable, high-level officer, director or partner who has the authority to bind the organization, as to the accuracy and completeness of the filing, and additional certifications with respect to any information that is subsequently submitted.

Clearly, the process of collecting the required information will be time- and labor-intensive for many parties, particularly for large multinational corporations, private equity firms and other entities with complicated ownership structures. Responding to subsequent requests for information also may be difficult, as the draft rules allow CFIUS to reject a filing if parties do not respond to information requests within 48 hours (unless CFIUS agrees to an extension of time). Since investors may be many time zones away, this 48 hour requirement—assuming it remains in the final regulations—may prove to be very problematic.

Penalties

As set forth in FINSA, the draft rules specifically provide for the imposition of penalties in certain circumstances. Under the draft rules, CFIUS may assess a penalty not to exceed \$250,000 per violation on any person who, intentionally or through gross negligence, submits a material misstatement or omission in a notice, makes a false certification to CFIUS or violates a mitigation agreement. The draft rules also specifically empower CFIUS to include in any mitigation agreement a provision for liquidated or actual damages in the event of breach, with the amount of liquidated damages set based on "a reasonable assessment of the harm to the national security that could result from a breach of the agreement." As CFIUS has never before had the authority to impose civil penalties, it is not possible to predict how CFIUS will implement this authority.

Going Forward

While the CFIUS review process remains, in many respects, fundamentally the same as it has been in the post-Dubai Ports World era, the draft regulations make some important changes and add to the already existing

uncertainty in the review process. The draft rules will sweep into the CFIUS process a range of transactions that were not previously subject to review, including, in particular, acquisitions of convertible debt and other future interests and investments from offshore investment vehicles otherwise under US control. Clearly, the draft rules represent an intentional effort by CFIUS to ensure that it has the broadest possible jurisdiction to review the widest possible range of transactions. The sweeping nature of the information collection process also will make the process more burdensome and costly for parties.

Although several trade groups announced their support immediately following the issuance of the draft rules, early indications are that several parties expect to file comments critical of key aspects of the draft rules. On May 2, 2008, the Treasury Department held a public meeting at which several individuals expressed concerns about the broad scope of the draft rules. Written comments, which are due by June 9, 2008, are expected to come primarily from trade groups and US companies. The extent to which the Treasury Department, in consultation with the other CFIUS member agencies, will take these comments into account in crafting the final rules is, of course, unclear.

The draft rules make it all the more important for parties interested in making investments in the United States to plan appropriately for the CFIUS review process. The expansiveness of the draft rules and the absence of precedent in applying certain of the new requirements will make the process all the more uncertain, particularly during the initial several months during which the new rules are applied. Accordingly, parties interested in making US investments need to develop appropriate strategies for successfully navigating this increasingly uncertain process.

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